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Texas Credit Union Department

REGULATORY BULLETIN

September 1, 1999 RB 1999-01

Guidance on Electronic Financial Services

BACKGROUND

Increasingly, credit unions are exploring business opportunities presented by technology, the Internet, and the World Wide Web. Credit unions are exploring these electronic areas to remain competitive, improve member service, and reduce their operating costs. As a general rule, credit unions do not have to inform the Department before using such electronic means and facilities for activities that they are otherwise authorized to perform or provide. Credit unions are, however, required to file a written notice with the Department before establishing a transactional web site and follow any procedures imposed in writing by the Department in response to any supervisory or compliance concerns that may affect your use of electronic means or facilities.

While electronic services will provide important benefits to credit unions and their members, they also will expose credit unions to new and different risks. As credit unions increase their dependency on technology to deliver services and process information, the risk of adverse consequences from operational failures increases. A credit union's effectiveness in controlling the risks inherent in the use of evolving technologies is directly related to its overall safe and sound operations. Credit unions that offer electronic financial services should create a safe, sound, and secure infrastructure that is adequate to mitigate risks associated with such activities. The Department will review technology-related risks together with all other risks to ensure that a credit union's risk management is integrated and comprehensive.

RISK AND CONTROLS

Before implementing an electronic financial services program, management should exercise due diligence and develop comprehensive plans to identify, assess, and mitigate potential risks and establish prudent controls. Such due diligence and planning would typically include the following activities:

- Review the implications of electronic financial services on the credit union's business plan;
- Evaluate member expectations and demands;
- Evaluate internal and external expertise and resource requirements to support the electronic financial services;
- Assess the risks and required controls, particularly those related to system security; and
- Develop effective policies and procedures that cover the program.

Electronic financial service activities involve a wide range of potential risks. Some of these are unique to the delivery channel, while others represent general concerns that are common to traditional credit union practices. When implementing electronic financial services, as with any new program, management must ensure that unique areas are identified and addressed. For example, new computer hardware and software may be needed to control security threats, while existing audit procedures will require expansion to incorporate the new system.

In general, electronic services related risks can be categorized as Strategic, Reputation, Compliance, and Transactional. Within these general risk areas, there are several concerns that are unique to electronic financial services. These categories are not mutually exclusive and each of the general risk areas are discussed more fully below, along with some examples of compensating controls.

Strategic Risk

Strategic risk exists in the business decisions that a credit union faces when new products or services are introduced. Specifically, this is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. The issues that each credit union should address for any new product or service are: (1) the development of a business plan which justifies the program; (2) availability of sufficient resources to support the program; (3) whether to outsource certain functions or perform them in-house; and (4) staying abreast of technological developments.

Business Plan

The decision to offer an electronic financial service program should be justified by a positive business plan. In developing the business plan, management should:

- Conduct Research and Consult with Experts – Management should consult with qualified technology, legal, economic, audit, regulatory, and other experts to evaluate pertinent issues.
- Perform Strategic Technology Planning – Technology planning is part of the strategic planning process. Credit unions should clearly define its goals and objectives in this area and allocate sufficient resources.
- Establish Goals and Monitor Performance – Performance goals measure the success of the electronic financial services program. The program should be reevaluated periodically in light of strategic plan modifications, member satisfaction and new technologies.

Internal and External Resources

The availability and cost of additional resources (internal and external) should be evaluated to determine their sufficiency relative to the demands of the electronic financial service program. The resources should be sufficient to:

- Provide Adequate Training – The credit union's staff should be properly trained to implement the program. Specifically, they should be educated on new security procedures and control practices. Qualifications of external personnel should be evaluated prior to contracting with the vendor.
- Provide Adequate Support Staff – Support staff (e.g., call center staff and customer service representatives) should be kept informed of any changes or updates to the program. Additional personnel may be needed to address an increased volume of member inquiries.
- Maintain Software Updates – Software changes require administrative controls. Credit unions may have to rely on members to install end-user software updates and accommodate those who are unable or unwilling to upgrade. Multiple software versions may have to be supported.
- Establish Adequate Insurance Coverage – Insurance providers should be consulted to confirm adequate coverage for electronic financial services activities.
- Monitor Inter-relationships – Inter-relationships among multiple financial institutions, vendors or originators, and participants within a payment system should be monitored to ensure transactions are completed in their entirety.

Outsourcing Arrangements

Outsourcing arrangements are commonly used for many aspects of electronic financial services programs. However, such arrangements must be properly initiated, documented, and managed. Insufficient control over a vendor can result in potential liability and embarrassment to a credit union. When a credit union plans to outsource part or all of its electronic financial services, it should:

- Perform Due Diligence on Vendors – Select only vendors who are knowledgeable of the emerging technology. Management should consider the vendor's financial condition and ability to provide ongoing services. It would also seem prudent to have the credit union's attorney review all contracts.
- Monitor Performance – The performance of the vendor should be monitored and compared to the provisions of the contract.
- Establish Back-up Arrangements – The possible inability of a vendor to fulfill its obligation should be considered by management. The degree of difficulty and cost to obtain a replacement should determine the extent to which back-up arrangements are considered.

Technological Developments

The dynamic nature of technology makes it incumbent on credit unions to maintain secure systems that meet member needs. A credit union's information technology plan should include consideration of future system upgrades as more sophisticated security techniques and user options are developed. To help ensure a secure electronic financial services program that continues to meet member needs, management should:

- Monitor New Developments – Schedule periodic evaluations of new technologies in hardware and software. Management should evaluate new products, services, and vendors against business plans and in light of the aforementioned risks.
- Budget for Technology Upgrades – Consideration should be given to the costs of technological upgrades to maintain appropriate security and adapt to member expectations.

Compliance Risk

Compliance risks arise from the uncertainty of how the electronic environment will affect legal framework, jurisdiction, and regulatory compliance. Specifically, this is the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risks expose the credit union to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance countermeasures generally consist of effective policies and procedures and comprehensive disclosures.

As credit unions move increasingly from paper to electronic-based transactions and information exchanges, they need to consider how laws designed for paper-based transactions apply to electronic-based transactions and information exchanges. Some new technologies raise unexpected compliance issues. Transactions conducted through the Internet also can raise novel questions regarding jurisdictional authority over those transactions. Therefore, credit unions should be careful to monitor and respond to changes to relevant laws and regulations arising from these developments.

Regulatory Compliance

The existing regulatory framework remains applicable in the electronic environment, but may require new interpretations. Management should consider the ramifications of members residing in distant locations who may have no physical contact with the credit union. At a minimum, management should:

- Update Policies and Procedures – Policies and procedures should be modified as needed to incorporate the electronic financial services program.
- Expand Internal and External Audit – Programs to monitor compliance with regulatory requirements should be expanded to include electronic delivery channels. Audit trails should be incorporated into each program or system. Ensure advertisements for products and services contain the proper disclosures in accordance with any federal or state laws.

Legal Framework

Many basic legal questions complicate electronic financial activities. The applicability of existing laws in an electronic environment is uncertain in many cases and credit unions must exercise caution when addressing legal issues related to electronic financial services. Management should consider:

- Detailed Contracts – When certain functions of electronic financial services are outsourced, detailed contracts are used to define the roles and responsibilities of the credit union and vendors. Contracts should include delineations of authority, responsibilities, and accountability; provide protective convenants; and address confidentiality, ownership of credit union records, and safety of members assets.
- Disclosures – Management should ensure that members are fully informed of the risks associated with their participation in an electronic financial services program. Member disclosures should explain the circumstances under which their account data may be at risk and the security methods employed by the credit union. Members must be informed of their rights and responsibilities in the event of unauthorized access.
- Privacy Issues – The Internet opens the door to new opportunities for credit unions; however, to capitalize on those opportunities, credit unions must reassure members that the credit union-member relationship – and the expectation of privacy that is an essential part of that relationship – will be honored as much on the Internet as it is in the branch office.

Transactional Risk

Transactional risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen events will result in unexpected losses. The integrity of data that is transmitted, processed, and stored must be protected from unauthorized access. Electronic financial services involve the use of delivery channels (e.g., public telephone networks and the Internet) that are generally outside the credit union's control. The global reach of these systems and the number of uncontrolled access points introduces heightened transactional risk. However, programs can be implemented to prevent, detect, and contain a system attack and protect confidential data.

Security

Security is the paramount issue, since access represents an opening of the computer system to outside and potentially unauthorized users. Although the devices and distribution channels may vary, the risk and control issues delineated in this document are generally applicable regardless of the type of access device or distribution channel.

System security requires implementation of proper controls to guard against unauthorized access to the credit union's networks, systems, and databases. Management should control user access to prevent a security compromise of internal systems. Member data must be protected from unauthorized access or altercation during transmission over public networks. Management should develop methods to maintain confidentially, ensure the intended person receives accurate information, and prevent eavesdropping by others. In addition, to ensure non-repudiation, undeniable proof of participation by both the sender and the receiver in a transaction must be created. Controls that management could implement include:

- Authorization – Authorization involves the pre-determination of permissible activities. Management should ensure that members have access only to their own accounts and perform only authorized functions.
- Access Control – Traditional access controls, such as user identification, passwords, and personal identification numbers, should be implemented for members using electronic financial services. However, since the effectiveness of these controls is greatly influenced by the member, management should take all possible steps to educate the members in this area.
- Authentication – Authentication is used to verify and recognize the identity of parties to a transaction. Credit unions may communicate with members they never physically meet resulting in opportunities for misrepresentations. Authentication is the primary component of non-repudiation.
- Secure Data Storage – Confidential information or highly sensitive data should be stored securely. Management should consider storing sensitive data in encrypted form and implementing stringent access controls.
- Encryption – Encryption technology disguises information to hide its meaning and enhances confidentiality by restricting information access to only intended users. Encryption-based methods can also be used to verify message authenticity and accuracy. Information is encrypted and decrypted with a cipher and key using specialized computer hardware or software. Secrecy of the key and complexity of the cipher are crucial for the success of encryption controls.
- Firewalls – Firewalls are physical devices, software programs, or both, that enhance security by monitoring and limiting access to computer facilities. They create a security barrier between two or more networks to protect the credit union's computer system from unauthorized entry. Filtering routers may be incorporated into the firewall system to screen data traffic and direct messages to certain locations.

Reputation Risk

Reputation risk is the risk to earnings or capital arising from negative member opinion. This affects the credit union's ability to establish new relationships or services, or to continue servicing existing members.

Reputation risk arises whenever electronic products, services, delivery channels, or processes may generate adverse public opinion such that it seriously affects a credit union's earnings or impairs capital. Examples may include: flawed security systems that significantly compromise member privacy; inadequate contingency and business resumption plans that affect a credit union's ability to maintain or resume operations and to provide member services following system failures; fraud that fundamentally undermines member trust; and large-scale litigation that exposes a credit union to significant liability and results in severe damage to a credit union's reputation. Adverse member opinion may create a lasting, negative image of overall credit union operations and thus impair a credit union's ability to establish and maintain member and business relationships.

Operations

System reliability requires that all aspects of the system are available and function as promised. Management should consider the risks created by reliance on systems whose performance is beyond their control. For example, management has little or no control over the performance of the Internet. System capacity and resource adequacy are considerations in meeting existing and anticipated volume. Consistency of operations should be ensured, including plans for recovery from service disruptions. To ensure the credit union has a reliable electronic financial services program, management should establish:

- Policies and Procedures – Policies can be used to delineate the board's expectations, benchmarks, and standard operating procedures.
- Contingency Plans – Contingency plans can be used to minimize business disruptions caused by problems that impair or destroy the credit union's processing and delivery systems. The plan should be tested periodically.
- Audit Procedures – The system should be auditable and designed with attention to controls, including segregation of duties. Qualified internal and external auditors should evaluate the system's controls periodically.

CONCLUSIONS

This guidance provides information for credit unions to consider during the design, development, implementation and monitoring of an electronic financial services program. The Department expects credit unions to identify, measure, monitor, and control its electronic-related risks and, as with all other risks, to avoid excessive exposure that may threaten the safety and soundness of the institution. Because electronic-related risks are important factors in assessing a credit union's overall risk profile, the Department's primary supervisory concern in reviewing a credit union's use of electronic services is whether the credit union is assuming a level of risk that exceeds its ability to manage and control the risk.

The Department understands and appreciates that credit unions currently address their electronic-related needs in different ways. For example, some credit unions incorporate technology planning into their overall strategic plans while others deal with technology applications on a project-by-project basis. The sophistication of the risk management process should be appropriate for the credit union's level of risk exposure. This includes the materiality of the risks, the degree of risk posed by electronic services as compared to, and when aggregated with, other credit union risks, and the overall ability of the credit union to manage and control its risks. Regardless of the specific credit union approach, sound risk management systems have several common fundamentals: risk identification, risk measurement, risk control, and risk monitoring.

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Texas Credit Union Department

REGULATORY BULLETIN

December 1, 1999 RB 1999-02

Guidance on Loan Participations

BACKGROUND

In recent months, high levels of liquidity have put greater pressure on credit union management to generate sufficient earnings to support operations. Because of this environment, some credit unions have elected to participate in loans with another credit union or organization. While there are many merits to participation lending, including the opportunity to diversify credit risk, it is an activity that requires strong policies and controls.

Credit unions must be diligent in underwriting participated loans or they may suffer unwanted consequences. Unfortunately, a few credit unions have failed to thoroughly investigate the terms and conditions of loan participation. As a consequence, they could very well incur losses because the true status of the purchased loan was either unknown, misunderstood, or misrepresented.

RESPONSIBILITIES

Credit unions have the following major responsibilities, both contractual and fiduciary, with regard to this type of lending:

1. **Perform an independent analysis of the loan.** The originating lender is responsible for obtaining all required documentation to comply with applicable state and federal laws. The originating lender should then provide copies of this information to each participating institution, and the participants are required to retain this information. We expect each party involved to perform an independent analysis of the loan and ensure that it meets their lending policies and standards.

2. **Assess the source of repayment.** It is paramount that each party involved independently assess the source of repayment. The originating lender is responsible for obtaining and distributing to participants a financial statement disclosing the borrower's ability to repay the loan, which is signed by the borrower and is current at the time that the loan application is made, or a written credit report prepared by the originating lender (or by others at the request of the lender). At the time an originating lender sells an interest in the loan, it must fully disclose to each participating institution all pertinent information in its possession concerning the financial condition of the borrower.

3. **Review the participation agreement carefully.** Although there are a number of ways a participation may be structured, the borrower customarily signs a note with the originating lender. The originating lender then sells an interest in that note to one or more institutions pursuant to the terms of a participation agreement. The participation agreement is usually the key document that spells out in detail all terms, conditions, and understandings between the originating lender and the participant. The participation agreement ordinarily establishes which party is paid first, what happens in the event of default, how various expenses are to be divided, and who is responsible to collect the note in the event of default. Each participating credit union should carefully review participation agreements and records and ensure that the parties share in the risks and contractual payments on a pro rata basis.

4. **Beware of informal repurchase agreements.** Credit unions should be wary of informal repurchase agreements, "gentleman's agreements," and similar arrangements. A credit union and its legal counsel are expected to be fully aware of the extent of contingent liability associated with each participated loan and the manner in which the loan will be handled and serviced.

5. **Monitor the status of the loan on an ongoing basis.** Each participant should monitor the status of the loan on an ongoing basis by obtaining timely information from relevant sources. Analysis of loan participation quality should capture trends in volume, delinquencies, roll rates[1], charge-offs, cash collections, collateral valuations, bankruptcies and prepayments, cure or workout programs, and exceptions. The ability to perform the level of analysis warranted depends on the accuracy, completeness, and timeliness of information obtained from the seller or servicer. The participation agreement should specify what types of reports the participant should receive on a periodic basis, including any financial performance reports on the borrower and/or business entity which may be required by the originating lender as a condition for the loan. Each participant should understand the causes of identified shifts and trends in loan participation quality and document actions taken to mitigate increasing risk levels.

6. **Maintain adequate records.** For participations secured by real estate, copies of the borrower's application, note, a mortgage instrument or similar document, and an appraisal of the security property must be retained. Records of a participation interest not secured by real estate must also include copies of the borrower's loan application, note, and any documents evidencing creation of a security interest. Regardless of the type of loan security, a participant must also retain documentation of the currency of the loan on the date of purchase, any agreement concerning loan servicing, and a copy of the loan originator's underwriting standards.

[1] Roll rates refer to the movement of accounts from one payment status to another; e.g., the percentage of 60-days-past-due accounts that "roll" to 90 days past due or, conversely, from 60 days past due to current. Calculations should capture both forward (worsening) and backward (improving) performance.

7. **Establish special reserve for nonconforming investments.** Any investments in participation loans to non-credit union members are considered nonconforming investments by the NCUA and, in accordance with Part 741.3 of NCUA Regulations, would require the credit union to establish a corresponding special reserve to cover the net excess of the investment's book value over its market value. If the market value cannot be appropriately established and documented, a reserve in an amount equal to the full book value must be established.

   Determining the adequacy of the special reserve requires detailed analysis using proper portfolio segmentation and loss estimation techniques. Reserve practices should be sufficiently robust to protect against losses, taking into consideration actual loss experience, trends in borrower and collateral profiles, and any changes in business or economic conditions.

In addition to the above discussion, the following list gives the general duties of the originating lender and participants. Originating lenders have the responsibility to:

- Comply with the participation agreement, consents required, and other contractual duties;
- Provide accurate, complete, and timely required reports and documents to the participant;
- Keep the participant informed of legal/business issues related to the borrower;
- Refrain from any activities that might be construed as competitive with the participant (e.g., make a loan directly to the borrower that is secured by a second lien on the collateral property underlying the participation); and
- Exercise similar controls and procedures over participations sold as for loans in its own portfolio.

Credit unions purchasing participation loans have the responsibility to:

- Ensure that adequate documentation is obtained and an independent analysis of credit quality is properly performed;
- Evaluate the risk of the proposed investment to determine whether the loan participation is consistent with the credit union's portfolio strategy and risk tolerance;
- Monitor the participation to ensure that the originating lender is fulfilling its duties and responsibilities;
- Obtain records in connection with loan participation purchases, including copies of such items as applications, notes, deeds of trust, and appraisals; and
- Subject participation loans purchased to the same critical review and documentation requirements as those loans originated by the credit union.

CONCLUSION

Each credit union is expected to have lending policies[2], practices, procedures, and internal controls that ensure that each participated asset is evaluated for credit quality, collectibility, and collateral sufficiency, and that it is in compliance with regulatory standards. Following safe and sound participation lending practices will help assure adequate revenues and prevent unexpected losses.

[2] Each credit union is expected to conduct its lending/investment activities prudently. Each institution should use lending and investment standards that are consistent with safety and soundness principles and are appropriate for the size and condition of the institution, the nature and scope of its operations, and conditions in its community. At a minimum, the credit union's policies for loan participations should set limits on the amount of risk that will be assumed – in total and by originating lender, address how the credit union will control portfolio quality, and avoid excessive exposure.

Texas Credit Union Department

REGULATORY BULLETIN

May 1, 2000 RB 2000-01

Guidance on Allowance for Loan and Lease Losses

BACKGROUND

This Bulletin provides guidance for establishing and maintaining the allowance for loan and lease losses (Allowance), one of the most important items affecting credit unions. The Allowance should result in a fair presentation of financial statements in conformity with generally accepted accounting principles (GAAP) and meet regulatory requirements for full and fair disclosure. Because of the importance of this issue, the Department believes credit unions must have clear and consistent guidelines to follow.

The Allowance is a valuation reserve established and maintained by charges against the credit union's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected.

Credit unions must establish an Allowance because there is credit risk in all loan and lease portfolios. The Allowance exists to cover the loan losses that occur in the loan portfolio of every credit union. As such, adequate management of the Allowance is an integral part of a credit union's credit risk management process.

PURPOSE OF THE ALLOWANCE

The Allowance is a valuation reserve maintained to cover losses that are probable and estimable on the date of the evaluation. The Allowance is not a cushion against possible future losses; that protection is provided by other reserves.

Although portions of the Allowance can be attributed to or based upon the inherent losses in individual loans and categories of similar loans, the Allowance is a general reserve available to absorb all credit losses that arise from the entire portfolio. No part of the Allowance should be officially segregated for, or allocated to, any particular asset or group of assets.

ESTABLISHING AN ADEQUATE ALLOWANCE

Every credit union must have a program to establish and regularly review the adequacy of its Allowance. The Allowance must be maintained at a level that is adequate to absorb all estimated inherent losses in the loan and lease portfolio as of its evaluation date. A credit union that fails to maintain an adequate Allowance is operating in an unsafe and unsound manner.

The Allowance must cover inherent losses in all outstanding loans and leases. The Allowance should also reflect all significant, existing conditions affecting the ability of members to repay. The availability of credit union income, whether ordinary or nonrecurring, should not be a factor in determining an appropriate level for the Allowance.

Recognizing Problem Loans

To establish an adequate Allowance, a credit union must be able to recognize when loans have become a problem. An effective review system and controls that identify, monitor, and manage asset quality problems in an accurate and timely manner are essential. Accordingly, each credit union shall maintain written policies approved by its board of directors that establish the necessary systems and controls. The policies shall specifically set forth the manner in which the loan and lease portfolio will be reviewed and analyzed to ensure compliance with the applicable requirements and the timely charge-off of loans, or portions of loans, when a loss has been confirmed.

To be effective, a review system must respond not only to the obvious indicators of a problem, such as delinquency. It should also recognize, to the extent practical and possible, more subtle warnings of conditions that may affect the ability of members to repay on a timely basis, such as deterioration in a member's financial condition or adverse market developments.

Regardless of whether a loan is unsecured or collateralized, credit unions must promptly charge off the amount of any confirmed loan loss. For unsecured loans, bankruptcy or protracted delinquency may confirm the fact of a loss and require a charge-off. For troubled, collateral-dependent loans, loss confirming events may include an appraisal or other valuation that reflects a shortfall between the value of the collateral and the book value of the loan, or a deficiency balance following the sale of the collateral.

Estimating Inherent Losses

Estimated inherent losses should reflect consideration of all significant factors that affect collectibility of the loans and leases as of the evaluation date. While either historical loss experience or migration analysis may provide a reasonable starting point, it is not, by itself, a sufficient basis to determine an adequate level. Management should also consider any factors that are likely to cause estimated losses to differ from historical loss experience or migration analysis, including but not limited to:

- Changes in lending policies and procedures, including underwriting, collection, charge-off, and recovery practices.
- Changes in local economic or business conditions.
- Changes in the volume or type of credit extended.
- Changes in the experience, ability, and depth of lending personnel.
- Changes in the volume or severity of past due, restructured, or classified loans.
- Changes in the quality of a credit union's loan review system or the degree of oversight by the board of directors.
- The existence of, or changes in the level of, any concentrations of credit.

Credit unions are also encouraged to use ratio analysis as a supplemental check for evaluating the overall reasonableness of the Allowance. Ratio analysis can be useful in identifying trends in the relationship of the Allowance to classified loans, to past due loans, to total loans and leases, and to historical charge-off levels. However, while such comparison can be helpful as a supplemental check of the reasonableness of the credit union's assumptions and analysis, they are not, by themselves, a sufficient basis for determining an adequate reserve level. Such comparisons do not eliminate the need for an analysis of the loan and lease portfolio and the factors affecting its collectibility.

One of the Department's examination objectives is to evaluate the soundness of the credit union's Allowance determination process. Much of what follows in this bulletin is devoted to a discussion of an analytical framework for estimating inherent losses and an adequate level for the Allowance.

Provisions for Individual Classified Loans

The classification of a loan reflects a judgement about the risks of default and loss associated with the loan. Loans have inherent loss when existing facts, conditions, and values suggest it is probable that the credit union will not collect some or all of its exposure to the member. The provision to the Allowance for loans analyzed individually must be sufficient to cover the inherent loss present as of the evaluation date.

The Allowance provision for all individually analyzed loans must be based on a reasonable and well documented estimate of the amount of the loss involved. Credit unions must document the rationale and justification for individually analyzed loans that are provided for at a rate that is below the historical loss rate for similar loans. Decisions to diverge from the credit union's historical experience for loans must be clearly supported by the nature of the collateral or other circumstances that distinguish the loan from similarly classified loans.

In some cases, it may not be practical or necessary for credit unions to analyze and provide for their smaller consumer loans on an individual, loan-by-loan basis. Instead, credit unions may provide for such credits as part of a pool of similar loans using historical loss experience for such loans, adjusted for current conditions.

Loans that are analyzed as part of a pool are subject to the same loss events as loans that are analyzed individually. The most common indicator of inherent loss in pools of loans is delinquency. Examples of other loss events are loss of a job, divorce, bankruptcy, or death.

Loss confirming events should cause the Allowance to be increased to reflect the potential loss estimate for these problem loans. For consumer loans, those events will be typically based on the thresholds established in Table 1, rather than by specific adverse information about the member. Of course, if a credit union receives adverse, member-specific information confirming the loss before a threshold date has passed, the Allowance should be adjusted immediately. All credit unions should be aware that the

Department no longer considers the 10-40-90 ratio to be a valid estimate of the loss exposure for problem loans.

Loans that have been individually analyzed and provided for in the Allowance should also be included in their respective pools of similar loans when determining the credit union's historical loss experience on such loans. To avoid double counting of the inherent losses, however, loans that have been provided for individually should be subtracted from the pool of loans before the historical loss factor is applied to the pool to establish the appropriate provision for the pool.

METHODOLOGIES FOR ANALYZING THE LOAN PORTFOLIO

Because no single approach has been determined to be the best, or appropriate, for all credit unions, the Department does not require that credit unions use a specific method to determine loss experience. The method a credit union uses will depend to a large degree upon the capabilities of its information systems. Acceptable methods range from a simple average of the credit union's loss experience over a period of years, to more complex "migration" analysis techniques.

In principle, the goal of any allowance methodology that applies loss experience to the current portfolio should be to provide for unconfirmed losses that probably exist as of the evaluation date. How that is accomplished, including the analysis time frames used, will depend upon the characteristics of the portfolio and the particular methodology.

Historical Analysis Periods

There is no fixed, historical period of time that should be analyzed by credit unions to determine average historical loss experience. During periods of economic stability in the credit union's markets, a relatively long period of time (e.g., five years) may be appropriate. However, during periods of significant economic expansion or contraction, the credit union may appropriately shorten the historical time period considered in order to more accurately estimate the credit union's inherent losses in the current economic climate. Alternatively, the credit union's analysis may weigh recent experience more heavily.

Migration Analysis

Migration analysis techniques, which vary widely between credit unions, are usually and most appropriately applied to pools of past due and/or classified loans. The past due and/or classified status of these loans are indicative of the fact that a loss event may or will likely occur.

The most basic forms of migration analysis focus on the classification history of a fixed population of loans that are ultimately charged off. More sophisticated forms of migration analysis track the loss experience on a rolling population of loans over a period of several years and involve the collection and analysis of a very large volume of historical data. Some of the most sophisticated analyses may factor in differences in underwriting standards between different "vintages" of loans, the geographic and demographic attributes of the loans, or the relative seasoning of the loans (e.g., variations in loss rates between auto loans that are less than one year old compared to more seasoned auto loans).

Like the historical average approach, the purpose of a migration analysis is simply to determine, based on the credit union's experience over a historical analysis period, what rate of loss the credit union has incurred on similarly criticized or past due loans. Generally speaking, if the migration analysis is being done on a fixed pool of loans, the analysis time frame should cover the resolution of all loans in the pool (i.e., the time period over which the loans are either paid off, returned to performing status, or charged off). If it is a rolling analysis, the analysis time frame typically covers a much longer period.

MANAGEMENT'S RESPONSIBILITY FOR THE ALLOWANCE

Credit union management must evaluate the adequacy of the Allowance prior to the distribution or posting of any dividends and convey its findings to the board of directors. Regulatory reports and other financial statements must accurately reflect the operating results and financial condition of the credit union for the reporting period. A significant misstated Allowance misrepresents the credit union's financial condition on its report of condition and income and is misconduct under Section 122.255 of the Texas Finance Code.

The credit union must document its evaluation process sufficiently to establish that the methods used and the factors considered by the credit union provide a satisfactory basis for determining an adequate level for the Allowance. At a minimum, the credit union must document the bases for provisions for individually analyzed loans and for either the historical loss percentages or the migration analysis used for the portfolio (including any subjective adjustments for current conditions). If large or unusual provisions are made to the Allowance, the credit union should be able to document that the need for the provision arose in the current period and did not result from inadequate provisions in prior periods.

EXAMINERS' REVIEW OF THE CREDIT UNION'S PROCESS

While credit unions are responsible for determining an adequate Allowance and adopting a reasonable methodology for doing so, the Department is responsible for reviewing the credit union's Allowance evaluation process and testing the adequacy of the Allowance balance. Examiners should accept management's estimates of an adequate level for the Allowance if the following conditions are satisfied:

* The credit union has maintained effective systems and controls for identifying, monitoring, and addressing asset quality problems in a timely manner; and
* The credit union has established an acceptable Allowance evaluation process that analyzes in a reasonable manner all significant factors that affect the collectibility of the portfolio.

However, if the credit union's Allowance evaluation process is deficient or is based on the results of an unreliable review system, the examiner will have to prepare an estimate of the amount of an appropriate Allowance, based on available information. The examiner's estimate should be based on an analysis of the credit union's portfolio using the following test as a guideline. While this method may produce results that approximate an acceptable Allowance under GAAP, it tends to be conservative, so care must be taken in interpreting the results.

1. **Review each delinquent or nonperforming loan and selected large loans and determine the amounts that are losses or doubtful of collection.** Refinancing and extension agreements without adequate payment history would be considered nonperforming. Add together the anticipated loss amount for each loan.

2. **Compute the credit union's 5-year average loss ratio.** The examiners will use their judgement to determine whether this is a reasonable ratio to apply to the balance of the loan portfolio in light of current economic conditions and unusually high or low charge-offs in prior periods. Multiply this ratio by total loans outstanding less balances for loans which have been individually classified and reserved for per step (1). For those credit unions which maintain sufficient detail, computing a loss ratio for each loan category (i.e., auto, real estate, member business, etc.) would be appropriate.

3. **The results of steps (1) and (2) above should be added together and the total compared to the Allowance account balance.** The balance should be adjusted if it is materially inaccurate.

Any significant deficiencies in the credit union's process for determining the level of the Allowance should be clearly detailed in the report of examination. Report comments should emphasize that the credit union's management is responsible for implementing an effective internal process that will ensure maintenance of an adequate Allowance. The report will also document the agreed upon corrective action necessary to improve the credit union's process.

ADJUSTMENTS TO THE ALLOWANCE

The examiner's estimate of an appropriate level for the Allowance should be used to determine whether there has been a significant misstatement of the operating results and the financial condition of the credit union. If the Allowance is determined to be significantly misstated, the examiner should determine whether it has been reviewed by an external auditor performing an audit. If so, the examiner should discuss his or her findings concerning the Allowance with the external auditor to ensure that all available information has been considered.

If, after considering all available information, the examiner concludes that the Allowance has been significantly misstated, credit union management should be requested to make the necessary adjustments to bring the Allowance to an appropriate level.

REGULATORY REPORTING AND ACCOUNTING REQUIREMENTS

The credit union must charge off loan and lease losses in the period when the loans, or portions of loans, are deemed uncollectible and of such little value that their continuance as appropriate assets is not warranted. If the Allowance is determined to be significantly misstated, the credit union must make the necessary adjustments in the quarter the determination is made. If it is clear that significant losses or provisions should have been recognized in a prior period, the Call report for that period must be amended and refiled.

CHANGES IN THE BALANCE OF THE ALLOWANCE

Adjustments to the Allowance resulting from the credit union's evaluation of its adequacy must be made through charges or credits to the "Provision for loan and lease losses" in the report of income. All charge-offs must be applied directly to the Allowance, and any recoveries on loans or leases previously charged off must be credited to the Allowance. Under no circumstances can loan or lease losses be charged directly to the undivided profits or regular reserve accounts.

The Allowance can never have a debit balance. If losses charged off exceed the amount of the Allowance, a provision sufficient to restore the Allowance to an adequate level must be charged to expenses immediately. A credit union must not increase the Allowance by transfers from the "Undivided profits" accounts or any segregation thereof.

RECOGNITION OF LOSSES IN CONNECTION WITH FORECLOSURES

When a credit union forecloses on a loan or lease, it must recognize a loss equal to the difference between the current fair value of the assets received in the foreclosure or similar settlement and the current carrying value of the loan or lease. That loss must be charged to the Allowance at the time of foreclosure or repossession.
When an asset is sold after being received in a foreclosure or repossession, differences between the estimated loss and the actual loss must be accounted for as follows:

- If the asset is sold soon after foreclosure or repossession (usually not more than 90 days), and the market price for it has not changed while it has been held, the value received in the sale must be substituted for the fair value estimated at the time of foreclosure or repossession and adjustments made to the loss charged against the Allowance.
- If the value has been affected by a change in the market since the foreclosure or repossession, or if the asset is held for more than a short period of time, any additional losses in value or any gains or losses from the sale or disposition of the asset is not a recovery or credit loss and must not be debited or credited to the Allowance. Such additional changes must be reported net on the report of income as "Other noninterest income" or "Other noninterest expense" as appropriate.

When a loan is charged off, any accrued but uncollected interest on the credit union's books from both current and prior periods should be charged against current earnings.

The one exception is when specific provisions have been made to the Allowance for uncollectible accrued interest. In that case, the accrued interest should be charged to the Allowance. For discounted loans, the unearned portion of the loan balance should be charged against the unearned discount account.

CONCLUSION

Every credit union must have a program to establish and regularly review the adequacy of its allowance. The allowance must be maintained at a level that is adequate to cover losses in the loan and lease portfolio that are probable and estimable on the date of the evaluation. This requires management to establish appropriate processes to recognize problem loans in a timely manner and a sound analytical process for estimating the amount of inherent loss in its loan and lease portfolio.

TABLE 1

Thresholds for Classifying Problem Loans

Loan Category	**Standard Devaluation**
All loans greater than 6 months delinquent	100% of loan balance
Loans 4-6 months delinquent – Unsecured	60% of loan balance
Loans 4-6 months delinquent – Secured	40% of loan balance
Loans 2-4 months delinquent – Unsecured	40% of loan balance
Loans 2-4 months delinquent – Secured	20% of loan balance
Loans less than 2 months delinquent	See below
Loan Category	**Devaluation Percentage**
* Deficiency balance after repossession and sale of collateral	100% of remaining loan balance
* Excessive extensions/refinancing of loan resulting in a material understatement of the delinquent status and loss exposure	100% of variance between collateral value and loan balance
* Loan to member filing for bankruptcy protection	100% of variance between collateral value and loan balance
* Substantial deficit in the loan/value ratio due to the addition of single interest insurance, previous delinquency, decline in the value of the collateral, etc.	100% of variance between collateral value and loan balance
* Material documentation deficiencies in home equity loans subject to the penalty provisions included in Section 50, Article XVI of the Texas Constitution	Up to 100% of the loan balance depending on the credit union's ability to correct the deficiencies
* Substandard documentation to support the organization's continued repayment ability for a member business loan	10% of the loan balance
* Key loan documents missing including the promissory note, security agreement, the credit union's lien, etc.	Up to 100% of the loan balance based on judgement of the loss exposure

Table 2
Deviations from Threshold
Circumstances that will normally warrant a reduction in the devaluation percentage include: * Strong loan/value ratio * Established repayment plan through the bankruptcy court * Material deposit relationship with the credit union * Acceptable cosigner or other guarantor * Positive repayment performance during the past 90 days
Circumstances that will normally warrant an increase in the devaluation percentage include: * Member filing for bankruptcy * Poor loan/value ratio * Poor repayment performance during the past 90 days * No payment or contact with the member within 60 days * Substandard documentation for a security interest or lien * Addition of single interest insurance * Member's loss of employment or other primary means of support

GLOSSARY OF TERMS

Collateral-dependent - A collateral-dependent loan relies solely on the operation or sale of the collateral for repayment. In evaluating the overall risk associated with a loan, the Department considers a number of factors, including the character, overall financial condition and resources, and payment record of the member; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of any underlying collateral. However, as other sources of repayment become inadequate over time, the importance of the collateral's value necessarily increases and the loan may become collateral dependent.

Inherent loss - The Department uses the term inherent loss to mean the amount of loss that meets the conditions of Statement of Financial Accounting Standards (FAS) No. 5 for accrual of loss contingency (i.e., a provision to the allowance). The term is also synonymous with the term "estimated credit losses".

FAS No. 5 is the primary, authoritative accounting document concerning the accrual of an allowance for loan and lease losses. It defines a "loss contingency" as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss that will ultimately be resolved when one or more future events occur or fail to occur. It might seem that the conditions associated with most loans involve some degree of uncertainty about collectibility. However, a provision to the Allowance for loan and lease losses for a loss contingency associated with loans should be made only if both of the following conditions of FAS No. 5 are met:

* Information available as of the evaluation date indicates that it is probable that the value of the loan has been impaired. (One or more future events must be likely to occur and confirm the fact of the loss.) FAS No. 114 clarifies this by stating:

"If, based on current information and events, it is probable that the enterprise will be unable to collect all amounts due according to the contractual terms of the receivable, the condition in [this] paragraph 8(a) is met. As used here, all amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments will be collected as scheduled according to the receivable's contractual terms. However, a creditor need not consider an insignificant delay or insignificant shortfall in amount of payments as meeting the condition in [this] paragraph 8(a)."

* The amount of loss can be reasonably estimated. (Under Financial Accounting Standards Board Interpretation No. 14, it is not necessary to specify a single amount. The ability to estimate a range of loss is sufficient to satisfy this condition.)

An inherent loss, therefore, is an unconfirmed loss that probably exists based on information available when the evaluation is made. The amount of the loss must be subject to reasonable estimation. It should be based on the credit union's current plans for collection and the realizable value of any collateral. If it is not probable that the loss exists, or if the amount of the loss cannot be reasonably estimated, no provision should be made to the allowance.

Significant misstatement - A significant error exists if its correction would result in:

* Changing any amount(s) reported in the Call Report's Statement of Financial Condition by more than 1 percent of total assets, provided the amount is greater than $10,000. This criterion must be applied to all supporting schedules of the Statement of Financial Condition.
* Changing any amount(s) reported in the Call Report - Income and Expense Statement and supporting schedules by more than 1 percent of total operating income, provided the amount is greater than $1,000.

Guidance on Information System Security

PART ONE – PREVENTION: Discusses the use of vulnerability assessment tools and penetration analyses. When used regularly, both techniques can be integral components of a credit union's information security program.

VULNERABILITY ASSESSMENT TOOLS

Vulnerability assessment tools, also called security scanning tools, assess the security of network or host systems and report system vulnerabilities. These tools can scan networks, servers, firewalls, routers, and applications for vulnerabilities. Generally, the tools can detect known security flaws or bugs in software or hardware, determine if the systems are susceptible to known attacks and exploits, and search for system vulnerabilities such as settings contrary to established security policies.

In evaluating a vulnerability assessment tool, management should consider how frequently the tool is updated to include the detection of any new weaknesses such a security flaws and bugs. If there is a time delay before a system patch is made available to correct an identified weakness, mitigating controls may be needed until the system patch is issued.

Generally, vulnerability assessment tools are not run in real-time, but they are commonly run on a periodic basis. When using the tools, it is important to ensure that the results from the scan are secure and only provided to authorized parties. The tools can generate both technical and management reports, including test, charts, and graphs. The vulnerability assessment reports can tell a user what weaknesses exist and how to fix them. Some tools can automatically fix vulnerabilities after detection.

Host- Versus Network-Based Vulnerability Assessment Tools

As in intrusion detection systems, which are discussed later in this appendix, there are generally two types of vulnerability assessment tools: host-based and network-based. Another category is sometimes used for products that assess vulnerabilities of specific applications (application-based) on a host. A host is generally a single computer or workstation that can be connected to a computer network. Host-based tools assess the vulnerabilities of specific hosts. They usually reside on servers, but can be placed on specific desktop computers, routers, or even firewalls. Network-based vulnerability assessment tools generally reside on the network, specifically analyzing the network to determine if it is vulnerable to known attacks. Both host- and network-based products offer valuable features, and the risk assessment process should help a credit union determine which is best for its needs. Information system personnel should understand the types of tools available, how they operate, where they are located, and the output generated from the tools.

Host-based vulnerability assessment tools are effective at identifying security risks that result from internal misuse or hackers using a compromised system. They can detect holes that would allow access to a system such as unauthorized modems, easily guessed passwords, and unchanged vendor default passwords. The tools can detect system vulnerabilities such as poor virus protection capabilities; identify hosts that are configured improperly; and provide basic information such as user log-on hours, password/account expiration settings, and users with dial-in access. The tools may also provide a periodic check to confirm that various security policies are being followed. For instance, they can check user permission to access files and directories, and identify files and directories without ownership.

Network-based vulnerability assessment tools are more effective than host-based at detecting network attacks such as denial of service and Internet Protocol (IP) spoofing. Network tools can detect unauthorized systems on a network or insecure connections to business partners. Running a host-based scan does not consume network overhead but can consume processing time and available storage on the host. Conversely, frequently running a network-based scan as part of daily operations increases network traffic during the scan. This may cause inadvertent network problems such as router crashes.

PENETRATION ANALYSIS

After the initial risk assessment is completed, management may determine that a penetration analysis (test) should be conducted. For the purpose of this Bulletin, “penetration analysis” is broadly defined. Credit union management should determine the scope and objectives of the analysis. The scope can range from a specific test of a particular information system’s security or a review of multiple information security processes in a credit union.

A penetration analysis usually involves a team of experts who identify an information system’s vulnerability to a series of attacks. The evaluators may attempt to circumvent the security features of a system by exploiting the identified vulnerabilities. Similar to running vulnerability scanning tools, the object of a penetration analysis is to locate system vulnerabilities so that appropriate corrective steps can be taken.

The analysis can apply to any credit union with a network, but becomes more important if system access is allowed via an external connection such as the Internet. The analysis should be independent and may be conducted by a trusted third party, qualified internal audit team, or a combination of both. The information security policy should address the frequency and scope of the analysis. In determining the scope of the analysis, items to consider include internal vs. external threats, systems to be included in the test, testing methods, and system architectures.

A penetration analysis is a snapshot of the security at a point in time and does not provide a complete guaranty that the system(s) being tested is secure. It can test the effectiveness of security controls and preparedness measures. Depending on the scope of the analysis, the evaluators may work under the same constraints applied to ordinary internal or external users. Conversely, the evaluators may use all system design and implementation documentation. It is common for the evaluators to be given just the IP address of the credit union and any other public information, such as a listing of officers that is normally available to outside hackers. The evaluators may use vulnerability assessment tools, and employ some of the attack methods discussed in this Bulletin such as social engineering and war dialing. After completing the agreed-upon analysis, the evaluators should provide the credit union a detailed written report. The report should identify vulnerabilities, prioritize weaknesses, and provide recommendations for corrective action.

A penetration analysis itself can introduce new risks to a credit union; therefore, several items should be considered before having an analysis completed, including the following:

- *If using outside testers, the reputation of the firm or consultants hired.* The evaluators will assess the weaknesses in the credit union's information security system. As such, the confidentiality of results and credit union data is crucial. Just like screening potential employees prior to their hire, credit unions should carefully screen firms, consultants, and subcontractors who are entrusted with access to sensitive data. A credit union may want to require security clearance checks on the evaluators. A credit union should ask if the evaluators have liability insurance in case something goes wrong during the test. The credit union should enter into a written contract with the evaluators, which at a minimum should address the above items.
- *If using internal testers, the independence of the testers from system administrators.*
- *The secrecy of the test.* Some senior executives may order an analysis without the knowledge of information systems personnel. This can create unwanted results, including the notification of law enforcement personnel and wasted resources responding to an attack. To prevent excessive responses to the attacks, credit union management may consider informing certain individuals in the organization of the penetration analysis.
- *The importance of the systems to be tested.* Some systems may be too critical to be exposed to some of the methods used by the evaluators such as a critical database that could be damaged during the test.

PART TWO – DETECTION: Discusses intrusion detection systems and using these tools as the detection component of a credit union's information security program.

INTRUSION DETECTION SYSTEMS

Vulnerability assessments and penetration analysis help ensure that appropriate security precautions have been implemented and that system security configurations are appropriate. The next step is to monitor the system for intrusions and unusual activities. Intrusions detection systems (IDSs) may be useful because they act as a burglar alarm, reporting potential intrusions to appropriate personnel. By analyzing the information generated by the systems being guarded, IDSs help determine if necessary safeguards are in place and are protecting the system as intended. In addition, they can be configured to automatically respond to intrusions.

Computer system components or applications can generate detailed, lengthy logs or audit trails that system administrators can manually review for unusual events. IDSs automate the review of logs and audit data, which increases the review's overall efficiency by reducing costs and the time and level of skill necessary to review the logs. Typically, there are three components to an IDS. First is an agent, which is the component that actually collects the information. Second is a manager, which processes the information collected by the agents. Third is a console, which allows authorized information systems personnel to remotely install and upgrade agents, define intrusion detection scenarios across agents, and track intrusions as they occur. Depending on the complexity of the IDS, there can be multiple agent and manager components.

Generally, IDS products use three different methods to detect intrusions. First, they can look for identified attack signatures, which are streams or patterns of data previously identified as an attack. Second, they can look for system misuse such as unauthorized attempts to access files or disallow traffic inside the firewall. Third, they can look for activities that are different from the user's or system's normal pattern. These "anomaly-based" products (which use artificial intelligence) are designed to detect subtle changes or new attack patterns, and then notify appropriate personnel that an intrusion may be occurring. Some anomaly-based products are created to update normal use patterns on a regular basis. Poorly designed anomaly-based products can trigger frequent false-positive responses.

Although IDSs may be an integral part of a credit union's overall system security, they will not protect a system from previously unknown threats or vulnerabilities. They are not self-sufficient and do not compensate for weak authentication procedures (e.g., when an intruder already knows a password to access the system). Also IDSs often have overlapping features with other security products, such as firewalls. IDSs provide additional protections by helping to determine if the firewall programs are working properly and by helping to detect internal abuses. Both firewalls and IDSs need to be properly configured and updated to combat new types of attacks. In addition, management should be aware that the state of these products is highly dynamic and IDS capabilities are evolving.

IDS tools can generate both technical and management reports, including text, charts, and graphs. The IDS reports can provide background information on the type of attack and recommend courses of action. When an intrusion is detected, the IDS can automatically begin to collect additional information on the attacker, which may be needed later for documentation purposes.

Host- versus Network-Based IDS Tools

As with vulnerability assessment tools, there are generally two types of IDS products: host-based and network-based. A third product category is sometimes used for IDSs that look for unusual application events (application-based) on a host. Both network- and host-based tools offer valuable features, and the risk assessment process should help credit unions determine if either, or a combination of both, is best for their needs.

Host-Based IDSs

Host-based IDSs are also known as audit trail analysis tools or server based IDSs (often placed on servers). A host-based IDS will look for potential intrusions or patterns of misuse by monitoring host event activities, audit logs, and other security-related activities. The tools will track audit trails form operating systems, applications, Web servers, routers, and firewalls, as well as monitor critical files for Trojan horses and unauthorized changes. This can provide valuable evidence of a break-in and can assist in assessing damage because the intruder's actions are logged on the specific hosts. If done in real-time, the IDS can promptly notify the credit union of unauthorized attempts to gain system administrator (root) controls, access or change critical files, or replace log-in programs.

An important benefit of host-based IDSs is that they are effective in detecting insider misuse because they monitor activities on the specific hosts. For example, they can monitor a user's attempt to access a restricted file or an attempt to execute a system administrator's command. In addition, they can monitor encrypted transmissions as the data is generally decrypted before it is logged at the host.

A problem with host-based systems is that notification of the attack is delayed if an agent does not examine the audit trail in real time. This problem relates to the relatively large consumption of computer processing speed and disk space that is required to run these programs in real time. If not run in real-time, they still allow the credit union to identify larger trends and problems with system security.

Network-Based IDSs

With network-based IDSs, software or sniffers are placed on one or multiple points across the network. The sniffer agent analyzes packets of information moving across the network for potential intrusions. Network packets contain data, including the message and headers that identify the sending and receiving parties. Network-based IDSs look for patterns of misuse, specific types of attacks, and unusual activity such as unexpected volume and types of network traffic. Compared to host-based IDSs, certain types of network-orientated attacks such as IP spoofing, packet floods, and denial of service, are best detected through packet examination.

Network-based IDSs can detect potential intrusions in real time, and offer concurrent notification and response capabilities to potential intrusions. The software does not need to be put on the various hosts throughout the network, thus it is generally easier to monitor and may be less expensive than host-based IDSs.

Network-based IDSs sometimes mistakenly identify normal traffic as an intrusion ("false positives") and vice versa ("false negatives"). They can have difficulties detecting slow attacks and experience problems with busy networks. Network-based IDSs cannot monitor encrypted transmission (only detect that data is being transferred across the network), and are less effective at detecting insider misuse because network packet analysis does not monitor the activities on specific hosts.

Factors to Consider in Evaluating IDSs

Once it is determined that an IDS is necessary to detect possible security breaches, several factors should be considered in evaluating IDSs, including:

- *The comprehensiveness of the attack signature database, including the frequency of updates that incorporate newly identified concerns.* Most products rely on vendor updates, so credit unions need to assess the timeliness of the IDS vendor's updates. Products can be updated through Internet downloads, CD-ROM or floppy disk updates, or even manually if the user has a sufficient degree of technical knowledge.
- *The effectiveness of the IDS in protecting a credit union from both internal and external threats to a computer system.* The IDS should limit the number of false positives (incorrectly identifying an attack when none has occurred) and false negatives (not identifying an attack when one has occurred).
- *The impact on performance of the network and/or host(s).* Generally, IDSs work on a real-time basis. Real-time analysis provides quicker notification of potential intrusions; however, it can reduce system performance due to the additional memory and processing requirements. Non-real-time analysis generally consumes fewer resources, but has the disadvantage that the potential intrusion has already occurred. Knowledgeable intruders, moreover, can manipulate audit trails, making the after-the-fact analysis useless in detecting these particular intruders.
- *The security of the IDS itself and how secure the update process is, especially if updated remotely.*
- *The reporting and automated response capabilities.* IDSs will sometimes generate more information than can be reviewed by present qualified staff. Also, for privacy reason, management should consider informing all affected systems users about the scope and type of monitoring being conducted.

Other things to consider include training and support from the vendor, cost of hardware, software, and maintenance agreements, integration with vulnerability assessment tools and configuration capabilities.

Determining which is Best for a Credit Union

A credit union's risk assessment process should first determine whether an IDS is necessary. Next, the type or placement of an IDS depends on the priority of identified threats or vulnerabilities. If one or a few hosts contain information that management views as critical, a host-based IDS may be warranted. If the information is less essential, other controls such as firewall and/or filtering routers may be sufficient to protect the information. If a credit union is primarily concerned with attacks from the outside or views the entire network system as critical, a network-based product may be appropriate. A combination of host- and network-based IDSs may also be appropriate for effective system security. Management should be aware that even after an IDS is in place, there may be other access points to the credit union's systems that are not being monitored. Management should determine what types of security precautions are needed for the other access points.

The placement of the IDS within the credit union's system architecture should be carefully considered. The primary benefit of placing an IDS inside a firewall is the detection of attacks that penetrate the firewall as well as insider abuses. The primary benefit of placing an IDS outside of a firewall is the ability to detect such activities as sweeping, which can be the first sign of attack; repeated failed log-in attempts; and attempted denial of service and spoofing attacks. Placing an IDS outside the firewall will also allow the monitoring of traffic that the firewall stops.

PART THREE – RESPONSE: Discusses implementing an incident response strategy for the response component of a credit union's information security program.

INCIDENT RESPONSE

After implementing a defense strategy and monitoring for new attacks, hacker activities, and unauthorized insider access, management should develop a response strategy. The sophistication of an incident response plan will vary depending on the risks inherent in each system deployed and the resources available to a credit union. In developing a response strategy or plan, management should consider the following:

- The plan should provide a platform from which a credit union can prepare for, address, and respond to intrusions or unauthorized activity. The beginning point is to assess the systems at risk, as identified in the overall risk assessment, and consider the potential types of security incidents.
- The plan should identify what constitutes a break-in or system misuse, and incidents should be prioritized by the seriousness of the attack or system misuse.
- Individuals should be appointed and empowered with the latitude and authority to respond to an incident. The plan should include what the appropriate responses may be for potential intrusions or system misuses.
- A recovery plan should be established, and in some cases, an incident response team should be identified.

- The plan should include procedures to officially report the incidents to senior management, the board of directors, legal counsel, and law enforcement agents as appropriate.

Today's products not only can detect intrusions in real time, but can automatically respond to intrusions. Depending on the software, information systems personnel can be notified on a real-time basis during an attack, rather than detect the attack afterward during a manual log review. Methods of notification can include e-mail, pager, fax, audio alarm, or message displays on a computer monitor. Responses can include shutting down the system, logging additional information, and disabling a user's account (e.g., by disallowing a particular user account or Internet address). Access can be disabled for a period sufficient for information system personnel to review the attack information or verify the user. Also, a credit union can add warning banners to protected systems, notifying users that they are accessing a protected computer system.

When determining an appropriate response, a distinction should be made between incidents in which actual changes to a system are suspected (e.g., changing audit logs) versus incidents in which system misuse is suspected (e.g., unauthorized system access). Attempts to actually change the system or data may warrant notifying senior management who could authorize the reconfigurement of the identified weakness and/or communication path. An appropriate response to system misuse may include automatic log-off, warning messages, or notifying the appropriate personnel.

Not only are attacks often undetected, in many cases identified attacks are not reported. Credit unions should develop a plan to response to unauthorized activities and involve law enforcement when appropriate.

Texas Credit Union Department

REGULATORY BULLETIN

August 15, 2000 RB 2000-03

Guidance on Credit Union Names

INTRODUCTION

The purpose of this Bulletin is to provide credit unions information and guidance on the selection and use of corporate names. As required by the Texas Finance Code, a credit union's corporate name must include the words "credit union" and an appropriate descriptive word or words, or an acronym made up of initials of the appropriate descriptive word or words and ending in "CU," approved by the commissioner. Normally, the commissioner cannot issue a certificate of incorporation to the credit union or approve the change of the name of the credit union if it would have the same name as another credit union or a name so nearly resembling the name of another credit union as to be calculated to deceive.

A credit union may only have one corporate name. The credit union must use its official corporate name in all official or legal communications or documents. For example, a credit union must use its official corporate name in any communications with the Department or other government agencies. Further, a credit union must use the official corporate name in legal documents such as consumer disclosures, contracts (including loans, lines of credit, and mortgages), real estate titles, lien registrations, securities, and all other documents purporting to bind the credit union to legal responsibilities or obligations. A credit union may, however, use an assumed name in other forms of communication, such as advertising.

A credit union may not do business under any name other than its corporate name until it has registered the designation with the Secretary of State and the appropriate county clerk, and has received from the commissioner a certificate of authority to use an assumed business name. The commissioner may not approve an assumed business name if the designation might mislead the public or is not readily distinguishable from, or is deceptively similar to, a name of another credit union lawfully doing business and that has established an office in this state unless the affected credit union consents, in writing, to the use of the name in question.

GENERAL GUIDELINES

The following guidelines will be the basis for the Department's approval of an assumed name or any future changes to a credit union's corporate name.

1. The corporate name is the initial means of identifying a legal entity; therefore, each name must be distinctive and distinguishable from existing credit unions' names.

2. The name may not be one that might falsely imply governmental affiliation.

3. Names must consist of letters of the English alphabet or a combination of such letters and Arabic numerals.
   a. Letters of the English alphabet will be used in every case. There are no guidelines with respect to capitalization, type, face, or font.
   b. Arabic numerals include: 0, 1, 2, 3, 4, 5 6, 7, 8, 9.
   c. A space or spaces after words, letters or numerals may be considered as part of the name.
   d. Roman numerals will be treated as letters of the English alphabet, but no name may consist entirely of Roman numerals.

4. A proposed name is deemed to be the "same" or "so nearly resembling" an existing credit union name if:
   a. The difference in the names exists in the use of different articles of speech.
      - Example: THE EDUCATION CREDIT UNION is deemed to be the "same" as EDUCATION CREDIT UNION.
   b. The difference exists in the use of punctuation, spaces and symbols.
      - Example: ABC CREDIT UNION is deemed to be the "same" as AB&C CREDIT UNION, A B C CREDIT UNION, A&BC CREDIT UNION, A.B.C. CREDIT UNION, A-B-C CREDIT UNION, or A*B*C CREDIT UNION.
   c. The difference exists in the presence or absence of letters which do not sufficiently alter the names to make them readily distinguishable.
      - Example: EXXON CREDIT UNION is deemed to be the "same" as EXON CREDIT UNION.
   d. The difference exists in obvious or well-known variant spellings which have the same pronunciation.
      - Example: SAGUARO CREDIT UNION is deemed to be the "same" as SAHUARO CREDIT UNION.
   e. The difference exists in the use of words with essentially the same meaning.
      - Example: HOUSTON REALTY CREDIT UNION is deemed to be the "same" as HOUSTON REAL ESTATE CREDIT UNION.

5. The adding of a city, direction, or other geographical designation to an existing corporate name does not create a more descriptive name; i.e., MEMBERS CREDIT UNION is deemed to be "so nearly resembling" MEMBERS CREDIT UNION OF DALLAS.

6. Only the proposed name and existing names in the state of Texas are considered when determining name availability.

OTHER CONSIDERATIONS

The Department's approval of an assumed name, corporate name, or a change in such names is only intended to eliminate false, misleading, or deceptive practices. Each credit union requesting a name change is also responsible for ensuring that the proposed name is in compliance with all other state or federal law applicable to corporate names. As a result, credit unions are advised to seek legal counsel and perform independent research before seeking approval of an assumed name or corporate name.

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REVISED – March, 2006

Texas Credit Union Department

REGULATORY BULLETIN

December 19, 2000 RB 2000-04

Guidance on Office Closing Notices

PURPOSE

This bulletin provides guidance to credit unions concerning requirements that a credit union must meet prior to any office being permanently closed.

BACKGROUND

Commission Rule 91.5005[1] provides that any credit union may permanently close any of its established offices. The credit union, however, must provide notice to its members and the Department no later than 60 days prior to the proposed closing. In addition, the credit union must post a notice to its members in a conspicuous manner on the premises of the effected office at least 30 days prior to the proposed closing.

APPLICABILITY

Commission Rule 91.5005 applies to the closing of an "office" by a credit union. The Department considers an "office" for purposes of this rule to be a traditional brick-and-mortar office or similar credit union facility, at which deposits are received, checks or share drafts paid, or money lent. Thus, for example, notice pursuant to the rule would not be required for the closing of an ATM.

A credit union must file an office closing notice whenever it closes an office, including when the closing occurs in the context of a merger, consolidation or other form of acquisition. The responsibility for filing the notice lies with the acquiring or surviving state-chartered credit union, but either party to such a transaction may give the notice. Thus, for example, the surviving credit union may give the notice prior to consummation of the transaction where the surviving credit union intends to close an office following consummation. In this example, if the transaction were to close ahead of schedule, the surviving credit union could operate the office to complete compliance with the 60-day requirements without the need for an additional notice.

The rule does not apply when an office is relocated. For purposes of this bulletin, an office relocation is a movement within the same immediate neighborhood that does not substantially affect the nature of the services or members served. Generally, relocations will be found to have occurred only when short distances are involved; for example, a move across the street, around the

[1] The provisions of Commission Rule 91.5005 were adopted to be effective March 13, 2006 and replaced Commission Rule 91.401(b).

corner, or a block or two away. Moves of less than five miles will generally be considered to be relocations. In less densely populated areas where neighborhoods extend farther and a long move would not significantly affect the nature of the services or the members served by the branch, a relocation may occur over substantially longer distances.

Consolidations of offices are considered relocations if the offices are located within the same neighborhood and the nature of the services or members served is not affected. Thus, for example, a consolidation of two offices on the same block following a merger would not constitute an office closing. The same standards apply to consolidations as to relocations.

Commission Rule 91.5005 does not apply when an office ceases operation but is not closed by a credit union. Thus, the rule does not apply to a temporary interruption of service caused by an event beyond the credit union's control (e.g., a natural catastrophe) if the credit union plans to restore credit union services at the site in a timely manner.[2]

NOTICE OF OFFICE CLOSING TO THE DEPARTMENT

The rule requires a credit union to give notice of any proposed office closing to the Department no later than 60 days prior to the date of the proposed office closing. The required notice should include the proposed date of closing and a detailed statement of the reason(s) for the decision to close the office.

NOTICE OF OFFICE CLOSING TO MEMBERS

The rule requires a credit union that proposes to close an office to provide notice of the proposed closing to its members. A credit union must include a member notice at least 60 days in advance of the proposed closing in at least one of the regular account statements mailed to its members, or, at the credit union's discretion, in a separate mailing. If the office closing occurs after the proposed date of closing, no additional notice is required to be mailed to members if the credit union acted in good faith in projecting the date for closing and in subsequently delaying the closing.

The mailed member notice should state the location of the office to be closed and the proposed date of closing, and either identify where members may obtain service following the closing date or provide a telephone number for members to call to determine such alternative sites.

Under Commission Rule 91.5005, a credit union must post notice to members in a conspicuous manner on the office premises at least 30 days prior to the proposed closing. This notice should state the proposed date of closing and identify where members may obtain service following that

[2] Commission Rule 91.5005 would apply, however, if the credit union were closed or did not reopen the office following the incident. Although prior notice would not be possible in such a case, the credit union should notify the members and the Department as soon as possible after the decision to close the office has been made. For notification requirements in the event of an emergency closing, refer to Commission Rule 91.5001.

date or provide a telephone number for members to call to determine such alternative sites. A credit union may revise the notice to extend the projected date of closing without triggering a new 30-day notice period.

In some situations, a credit union, in its discretion and to expedite transactions, may mail and post notices to members of a proposed branch closing that is contingent upon an event. For example, in the case of a proposed merger or consolidation, a credit union may notify members of its intent to close an office upon approval by the appropriate credit union regulatory agencies of the proposed merger or consolidation.

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Texas Credit Union Department

REGULATORY BULLETIN

August 23, 2001 RB 2001-01

Guidance on the Civil Asset Forfeiture Statute[1]

PURPOSE

This bulletin is intended to alert credit unions to major revisions to the Code of Criminal Procedure Chapter 59, the civil asset forfeit statute, which authorizes and establishes a procedure for state law enforcement to seize and forfeit property related to criminal offenses.

BACKGROUND

The scope of the Code of Criminal Procedure Chapter 59 is broad, and offenses that give rise to seizure and forfeiture generally include any felony offense. Property that is subject to seizure and forfeiture is statutorily referred to as "contraband", and includes any: (i) property used in the commission of or to facilitate the crime; (ii) the proceeds of the crime; and (iii) property derived from or purchased with proceeds of the crime. Not infrequently, a financial institution holds property that may be subject to seizure and forfeiture by the State.

During the 77th Regular Session, the Texas Legislature amended Chapter 59. Senate Bill 626, which becomes effective on September 1, 2001, expands the protection afforded innocent lienholders and significantly changes the procedures that apply to the seizure of contraband held at financial institutions. To put these changes and their significance in context, we believe it is helpful to briefly discuss some of the more problematic aspects of the prior law before explaining the recent amendments.

TEXAS LAW FROM 1989 TO PRESENT

Before the enactment of Senate Bill 626, Chapter 59 required a lienholder with a bona fide security interest in contraband other than real property to prove two things in order to protect that interest from forfeiture: one, that the security interest was acquired prior to or

[1] Working together with the Texas Department of Banking, the Department is recommending action in regards to the risk that accounts held at a financial institution, or assets in which a financial institution has a security interest will be seized and forfeited to the State.

during the commission of the offense; and two, that at the time the security interest was acquired and perfected, the lienholder did not know or have reason to know of the criminal offense or that it was likely to occur. A credit union that acquired a perfected security interest in contraband after the time the crime was committed lost that security interest no matter how "innocent" or ignorant of the crime the credit union may have been.

The failure to protect an innocent lienholder that acquired and perfected a security interest after the commission of the crime was not the only problem that Chapter 59 created for credit unions. Chapter 59 also authorized the State to withdraw seized contraband from a credit union immediately upon service of the seizure warrant. Such action, depending upon the amount of the seizure in relation to the credit union's net worth and assets, could jeopardize the credit union's liquidity and potentially precipitate a de facto insolvency and credit union closing. Additionally, Chapter 59 includes no provision for the sharing of information with, or giving notice to, the Department regarding contemplated asset seizures that could adversely affect a credit union.

TEXAS LAW EFFECTIVE SEPTEMBER 1, 2001

The revised law addresses these problems by: 1) recognizing the rights of the innocent lienholder who acquires and perfects its security interest after the commission of the offense but before the seizure of the property; 2) establishing specific procedures for the seizure of accounts and assets at financial institutions; and 3) authorizing, and in some instances requiring, law enforcement's disclosure of information to the Texas Banking Department in those instances when an employee of a financial institution is suspected to be involved in the crime.

Protection of Security Interests of Bona Fide Lienholders

The revised law continues to recognize the rights of the bona fide lienholder that acquires and perfects its security interest, in what is later determined to be contraband, before or during the commission of a criminal act that gives rise to forfeiture. It does not change what the lienholder must establish in order to keep its interest from being forfeited. Section 59.02(c) still requires the lienholder to establish that, at or before the time of acquiring and perfecting the interest, the lienholder did not know or should not reasonably have known of the act or omission giving rise to the forfeiture, or that it was likely to occur.

Unlike the prior law, however, the revised statute permits the lienholder who acquires and perfects its security interest after the commission of the offense, but before the seizure of the property, to protect that interest. To prevent the after-acquired security interest from being subject to forfeiture, the lienholder must establish that: 1) it was an interest holder for value at the time the interest in the property was acquired; and 2) it was "without reasonable cause to believe that the property was contraband and did not purposefully avoid learning that the property was contraband." The new law also specifically provides that the rights of lienholders in seized property remain in effect while the forfeiture proceedings are pending as if the property had remained in the lienholder's possession.

Procedures for Seizure of Accounts and Assets at Financial Institutions

The revised law establishes specific procedures to govern the seizure of contraband held at a financial institution when the contraband consists of depository accounts or assets in which the institution has a security interest. A credit union served with a seizure warrant has two options:

1. Pay the account or tender the assets at the time the warrant is served; or

2. Transfer the account to a segregated, interest-bearing account in the name of the attorney representing the state as trustee, where the account funds or assets must remain until disposed of by final order of the court in the forfeiture proceeding.

   If the credit union chooses option (2), the credit union must:

   A. freeze and segregate the account or assets immediately upon service of the seizure warrant; and,
   B. provide the peace officer with evidence, certified by a credit union officer, of the terms and amount of the account or a detailed inventory of the assets.

Except as authorized by the statute, no transaction involving the account or assets, other than the deposit or reinvestment of interest, dividends or similar payments, can occur without court approval.

If the credit union fails to release or transfer the account or asset as required by statute, and cannot comply with the court's final forfeiture order certain sanctions apply. The court can order the credit union and its culpable officers, agents and employees to pay actual damages, attorney's fees and court costs. Additionally, the court may find the credit union and those culpable persons in contempt.

The new law establishes a safe harbor from liability for a credit union that complies with its provisions.

Disclosure and Notice Provisions

The revised law authorizes the attorney representing state law enforcement to disclose information to the Banking Commissioner, including confidential information, relating to an actual or contemplated seizure involving a depository account in a financial institution or assets held by a financial institution as security for an obligation owed to the institution.

The state law enforcement attorney must notify the Banking Commissioner before taking any action under Chapter 59 that implicates a potentially culpable financial institution officer or director. The Banking Commissioner is then required to notify the Credit Union Commissioner if the financial institution is a Texas-chartered credit union.

The information disclosed to the Texas Banking Commissioner, and the Department, is confidential, and anyone who knowingly discloses the information except as authorized by the statute, is subject to penalties.

SUGGESTED ACTIONS

What does this mean? What must a credit union do to protect itself against the risk that accounts held at the credit union, or, more importantly, assets in which the credit union has a security interest, will be seized and forfeited to the State?

1. Credit unions should heighten their awareness of their members, especially new relationships and those borrowers that deal in cash and cash equivalent assets. Credit unions should fully understand the nature of a borrower's business, and perform and document background and reference checks for further assurance about the integrity of a borrowing relationship. *(A key component of the law's revision places emphasis on the credit union to know its members. Should the credit union find itself in a seizure and forfeiture situation, the extent of that knowledge, and due diligence that is evidenced, will be critical.)*

2. When necessary, credit unions should adequately document the origin of loan collateral to the fullest extent possible. Supporting documentation could include a bill of sale, purchase money invoice, or a closing settlement statement for real property. Certificates of deposit, equitable securities, and bonds held by third party institutions can present special challenges in determining the nature of their genesis. Prior years' tax returns should receive close review to determine possible asset holdings, sales, and investment capabilities. Additionally, credit union statements may need review to ascertain the extent of cash transactions.

3. Understand the use of loan proceeds. Purchase money loans should be well documented with invoices and when possible, credit union checks made payable to the selling party and the borrowing member. Member accounts that receive deposited loan proceeds should be periodically reviewed in order that the intended use of the proceeds can be collaborated with their disposition.

4. The Board and management should formulate policies and procedures in the event that the credit union is served a notice of seizure. At a minimum the policy should address the following:

    A. Who is responsible for coordinating and interfacing with law enforcement officials (*includes branch locations*);
    B. How will different assets be segregated and who will be responsible for monitoring the segregated accounts (*should the credit union chose to retain, and not immediately turn funds over to law enforcement, the amount of funds held by the credit union and verified by the credit union at the time of inquiry, should be the same amount the credit union has provided credit to the member, i.e., collected funds*); and,
    C. How and when will the board be notified.

A copy of Senate Bill 626 and the Legislative bill analysis is available for review at http://www.capitol.state.tx.us/tlo/billnbr.htm.

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Texas Credit Union Department

REGULATORY BULLETIN

September 19, 2001 RB 2001-02

Communication with External Auditors

PURPOSE

The Department is issuing this bulletin to improve the coordination and communication between external auditors and examiners. This bulletin provides guidelines regarding information that should be provided by credit unions to their external auditors and meetings between external auditors and examiners in connection with examinations.

BACKGROUND

The Department recognizes that the cooperative efforts of examiners, credit unions, and external auditors are essential to conducting a thorough examination. The sharing of information and discussions of the methodologies used enable examiners and auditors alike to develop a more complete understanding of the condition of a credit union. Further, this cooperation allows both parties to maximize the effectiveness of their resources by utilizing each other's work. This is particularly important since the Department is seeking to reduce regulatory burden by tailoring the scope of examinations to avoid unnecessary duplication of the work performed by external auditors.

COORDINATION OF EXTERNAL AUDITS AND EXAMINATIONS

In most cases, the Department provides credit unions with advance notice of the starting date(s) of examinations. When notified, a credit union is encouraged to promptly advise its external auditor of the date(s) and scope of supervisory examinations in order to facilitate the auditor's planning and scheduling of audit work. The external auditor may also advise the Department regarding the planned dates for auditing work on the credit union's premises in order to facilitate coordination with the examiners.

Some credit unions prefer that audit work be completed at different times from examination work in order to reduce demands upon their staff members and facilities. On the other hand, some institutions prefer to have audit work and examination work performed during similar periods in order to limit the impact of these efforts on the credit union's operations to certain times during the year. By knowing in advance when examinations are planned, credit unions have the flexibility to work with their external auditors to schedule audit work concurrent with examinations or at separate times depending upon management's preference.

OTHER INFORMATION PROVIDED BY THE CREDIT UNION[1]

Consistent with prior practice, a credit union should provide its external auditors with a copy of certain reports and supervisory documents, including:

- The most recent Report of Condition (i.e., "Call Reports, NCUA Form 5300");
- The most recent examination report and pertinent correspondence received from the Department;
- Any supervisory action with the credit union that has been put into effect since the beginning of the period covered by the audit; and
- Any written agreement between the Department and the credit union that has been put into effect since the beginning of the period covered by the audit.

EXTERNAL AUDITOR ATTENDANCE AT MEETINGS

Generally, the Department will not interpose an objection to auditors attending examination exit conferences upon completion of field work or other meetings between examiners and a credit union's management or Board of Directors (or a committee thereof) at which examination findings are discussed that are relevant to the scope of the audit. When other conferences between examiners and management are scheduled (i.e., that do not involve examination findings that are relevant to the scope of the external auditor's work), the credit union shall first obtain the approval of the Department in order for the auditor to attend the meetings. This guideline does not preclude the Department from holding meetings with the management of a credit union without auditor attendance or from requiring that the auditor attend only certain portions of the meetings.

Credit unions should ensure that their external auditors are informed in a timely manner of scheduled exit conferences and other relevant meetings with examiners and of the Department's guidelines regarding auditor attendance at such meetings.

[1] A refusal by a credit union to allow the external auditor to review communications from the Department would ordinarily be a limitation on scope of the audit sufficient to preclude an opinion (see paragraph 7 of the American Institute of Certified Public Accountants Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements*).

MEETINGS AND DISCUSSIONS BETWEEN AUDITORS AND EXAMINERS

An external auditor may request a meeting with the Department in order to inquire about supervisory matters relevant to the credit union under audit. External auditors should provide an agenda in advance to the Department. The Department will generally request that management of the credit union under audit be represented at the meeting. In this regard, examiners generally will only discuss with an auditor examination findings that have been presented to the credit union's management.

In certain cases, external auditors may wish to discuss with the Department matters relevant to the credit union under audit at meetings without the representatives from the credit union's management. External auditors may request such confidential meetings with the Department and the Department may also request such meetings with the external auditor.

CONFIDENTIALITY OF SUPERVISORY INFORMATION

While these guidelines permit external auditors to have access to the previously mentioned information on credit unions under audit, credit unions and their auditors are reminded that information contained in examination reports and supervisory discussions – including summaries or quotations – is confidential supervisory information and must not be disclosed to any party. The Department may request under certain circumstances that the external auditors sign a confidentiality agreement. Regardless, unauthorized disclosure of confidential supervisory information may result in civil and criminal actions and fines and other penalties.

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Texas Credit Union Department

REGULATORY BULLETIN

October 22, 2001 RB 2001-03

Guidance on Nondeposit Investment Sales

BACKGROUND

Increasingly, credit unions are expanding their activities to include recommending or selling nondeposit investment products, such as mutual funds and annuities, to their members. In response to the increased activity, this Bulletin was developed to provide guidance to credit unions on various issues raised by nondeposit investment sales. Each credit union should address these issues in a manner appropriate to the nature and extent of nondeposit investment sales activities conducted by its organization.

INTRODUCTION

The ability of credit unions to sell diverse and complementary financial products and services helps members to meet specific financial objectives, benefits members by promoting competition, and can make these products and services available to members that are underserved or unserved by other distribution systems.

Adequate member protections, qualified employees, and appropriate sales practices are key to responsible nondeposit investment sales activities. The Department is committed to ensuring that credit unions' nondeposit investment sales activities meet high standards.

Sales activities for nondeposit investment products should ensure that members are clearly and fully informed of the nature and risks associated with these products. In particular, where nondeposit investment products are recommended or sold to members, credit unions should ensure that members are fully informed that the products:

- Are not insured by the NCUSIF;
- Are not deposits or other obligations of the credit union and are not guaranteed by the credit union; and
- Are subject to investment risks, including loss of principal invested.

Additionally, sales activities involving these investment products should be designed to minimize the possibility of member confusion and to safeguard the credit union from liability under the applicable anti-fraud provisions of federal law, which, among other things, prohibit materially misleading or inaccurate representations in connection with the sale of certain products or services.

APPLICABILITY

This Bulletin applies when recommendations or sales of nondeposit investment products are made by:

- Employees of the credit union;
- Employees of a third party, which may or may not be affiliated with the credit union (including telephone sales or recommendations by employees or from the credit union's premises and sales or recommendations initiated by mail from its premises); and
- Sales resulting from a referral of members by the credit union to a third party when the credit union receives a benefit for the referral.

POLICIES AND PROCEDURES

A credit union involved in the activities described above for the sale of nondeposit investment products should adopt a written statement that addresses the risks associated with the sales program and contains a summary of policies and procedures outlining the features of the credit union's program that addresses, at a minimum, the concerns described in this Bulletin. The written statement should address the scope of activities of any third party involved, as well as the procedures for monitoring compliance by third parties in accordance with the guidelines below. The scope and level of detail of the statement should appropriately reflect the level of the credit union's involvement in the sale or recommendation of nondeposit investment products. The credit union's statement should be adopted and reviewed periodically by its board of directors. Credit unions are encouraged to consult with legal counsel with regard to the implementation of a nondeposit investment product sales program.

The credit union's policies and procedures should include the following:

- **Compliance procedures.** The procedures for ensuring compliance with applicable laws and regulations and consistency with the provisions of this Bulletin.
- **Supervision of sales personnel.** A designation by senior management of specific individuals to exercise supervisory responsibility for each activity outlined in its policies and procedures.
- **Types of products sold.** The criteria governing the selection and review of each type of product sold or recommended.
- **Permissible use of member information.** The procedures for the use of information regarding members for any purpose in connection with the sale of nondeposit investment products.
- **Designation of employees to sell products.** A description of the responsibilities of those personnel authorized to sell nondeposit investment products and of other personnel who may have contact with members concerning the sales program, and a description of any appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each class of personnel.

ARRANGEMENTS WITH THIRD PARTIES

If a credit union directly or indirectly engages in activities as described above under which a third party sells or recommends nondeposit investment products, the credit union should, prior to entering into the arrangement, conduct an appropriate review of the third party. The credit union should have a written agreement with the third party that is approved by the credit union's board of directors. Compliance with the agreement should be periodically monitored by the credit union's senior management. At a minimum, the written agreement should:

- Describe the duties and responsibilities of each party, including a description of permissible activities by the third party on the credit union's premises; terms as to the use of the credit union's space, personnel, and equipment; and compensation arrangements for personnel of the credit union and the third party.
- Specify that the third party will comply with all applicable laws and regulations and will act consistently with the provisions of this Bulletin and, in particular, with the provisions relating to member disclosures.
- Authorize the credit union to monitor the third party and periodically review and verify that the third party and its sales representatives are complying with its agreement with the credit union.
- Authorize the credit union and the Department to have access to such records of the third party as are necessary or appropriate to evaluate such compliance.
- Require the third party to indemnify the credit union for potential liability resulting from actions of the third party with regard to the investment product sales program.
- Provide for written employment contracts, satisfactory to the credit union, for personnel who are employees of both the credit union and the third party.

GENERAL GUIDELINES

1. Disclosures and Advertising

The Department believes that recommending or selling nondeposit investment products to members should occur in a manner that assures that the products are clearly differentiated from insured shares and deposits. Conspicuous and easy to comprehend disclosures concerning the nature of nondeposit investment products and the risk inherent in investing in these products are one of the most important ways of ensuring that the differences between nondeposit products and insured shares and deposits are understood.

Content and Form of Disclosure. Disclosures with respect to the sale or recommendation of these products should, at a minimum, specify that the product is:

- Not insured by the NCUSIF;
- Not a deposit or other obligation of , or guaranteed by, the credit union; and
- Subject to investment risks, including possible loss of the principal amount invested.

The written disclosures described above should be conspicuous and presented in a clear and concise manner. Credit unions may provide any additional disclosures that further clarify the risks involved with particular nondeposit investment products.

Timing of Disclosure. The minimum disclosures should be provided to the member:

- Orally during the sales presentation,
- Orally and in writing prior to or at the time an investment account is opened to purchase these products, and
- In advertisements and other promotional materials, as described below.

A statement signed by the member should be obtained at the time such an account is opened, acknowledging that the member has received and understands the disclosures.

Confirmations and account statements for such products should contain at least the minimum disclosures if the confirmations or account statements contain the name or the logo of the credit union. If a member's periodic share account statement includes account information concerning the member's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the share accounts, and should be introduced with the minimum disclosures and the identify of the entity conducting the nondeposit transaction. (Note: These minimum disclosures are in addition to any other disclosures required by applicable law.)

Advertisements. Advertisements and other promotional and sales material, written or otherwise, about nondeposit investment products should conspicuously include at least the minimum disclosures discussed above and must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of NCUSIF insurance. The minimum disclosures should also be emphasized in telemarketing contacts. Any third-party advertising or promotional material should clearly identify the company selling the nondeposit investment product and should not suggest that the credit union is the seller. If brochures, signs, or other written material contain information about both insured shares and nondeposit investment products, these materials should clearly segregate information about nondeposit investment products from the information about shares and other insured deposits.

2. Sales Area

Selling or recommending nondeposit investment products on the premises of a credit union may give the impression that the products are NCUSIF-insured or are obligations of the credit union. To minimize member confusion with share and deposit accounts, sales or recommendations of nondeposit investment products on the premises of a credit union should be conducted in a physical location distinct from the area where shares and deposits are taken. Signs or other means should be used to distinguish the investment sales area from the share- and deposit-taking area of the credit union. However, in the limited situation where physical consideration prevent sales of nondeposit products from being conducted in a distinct area, the credit union has a heightened responsibility to ensure appropriate measures are in place to minimize member confusion.

In no case, however, should tellers and other employees, while located in the routine share- and deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may refer members to individuals who are specifically designated and trained to assist members interested in the purchase of such products.

3. Qualifications and Training

The credit union should ensure that its personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products are adequately trained with regard to the specific products being sold or recommended. Training should not be limited to sales methods, but should impart a thorough knowledge of the products involved, of applicable legal restrictions, and of member protection requirements. If credit union personnel sell or recommend securities, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives.

Credit union personnel with supervisory responsibilities should receive training appropriate to that position. Training should also be provided to employees of the credit union who have direct contact with members to ensure a basic understanding of the credit union's sales activities and the policy of limiting the involvement of employees who are not authorized to sell investment products to member referrals. Training should be updated periodically and should occur on an ongoing basis.

Credit unions should investigate the backgrounds of employees hired for their nondeposit investment products sales program, including checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry experience.

4. Suitability and Sales Practices

Credit union personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard, if credit union personnel recommend nondeposit investment products to members, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular member on the basis of information disclosed by the member. Personnel should make reasonable efforts to obtain information directly from the member regarding, at a minimum, the member's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that member. This information should be documented and updated periodically.

5. Compensation

Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by members. However, whenever an employee is compensated for a sale or referral, the credit union needs to be sensitive to the concern that the employee might be motivated by the prospect of financial reward for the sale or referral rather than the best interest of the member. Accordingly, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to members and the credit union should clearly communicate to its sales personnel that it is unacceptable to engage in high pressure sales tactics.

Credit unions compliance and audit personnel should not receive incentive compensation directly related to results of the nondeposit investment sales program.

6. Compliance

Credit unions should develop and implement policies and procedures to ensure that nondeposit investment product sales activities are conducted in compliance with applicable laws and regulations, the credit union's internal policies and procedures, and in a manner consistent with this Bulletin. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. The compliance procedures should also provide for a system to monitor member complaints and their resolution. Where applicable, compliance procedures also should call for verification that third party sales are being conducted in a manner consistent with the governing agreement with the credit union.

The compliance function should be conducted independently of nondeposit investment product sales and management activities. Compliance personnel should determine the scope and frequency of their own review, and findings of compliance reviews should be periodically reported to the credit union's board of directors.

CONCLUSIONS

The Department's evaluation of a credit union's nondeposit investment sales activities will be guided by the Department's supervision-by-risk approach, which focuses on identifying problems, or potential problems, in individual credit unions or the credit union system, and ensuring that problems are appropriately corrected. The Department applies this philosophy in all supervisory activities it conducts.

The types of risk most likely to arise in connection with nondeposit investment sales include reputation risk, compliance risk, transaction risk, and strategic risk. In general, experience has demonstrated that credit unions conduct their nondeposit investment sales activities in a safe and sound manner and that their activities have been responsive to the interest of their members.

The Department believes that it can identify and focus on key indicators of potential problems with a credit union's sales of nondeposit investments as part of the examination process, and will be developing additional instructions to guide its examiners in this area.

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Texas Credit Union Department

REGULATORY BULLETIN

December 27, 2001 RB 2001-04

Guidance on Loans Secured by Readily Marketable Collateral

BACKGROUND

The Department supports credit union involvement in lending activities that are legal, creditworthy and consistent with sound credit union principles; such activities include extensions of credit secured by readily marketable collateral. However, due to the more complicated nature and level of risk associated with such loans, it is necessary that the credit union's board of directors and management ensure that sound policies and procedures are in place to govern their involvement in this lending area.

Credit unions should recognize the additional risk inherent in this type of lending and determine if these risks are acceptable and controllable given the credit union's staff, financial condition, size, and level of capital. Credit unions that engage in this type of lending must have board-approved policies and procedures, as well as internal controls that identify and control these additional risks.

PURPOSE

The purpose of this Bulletin is to provide a general overview of the special considerations related to loans secured by readily marketable collateral.

DEFINITION

For the purposes of this Bulletin, readily marketable collateral must be financial instruments or bullion that can be promptly sold under ordinary market conditions at a fair market value determined by reliable and continuously available price quotations, based upon actual transactions on an auction or similarly available daily bid and ask price market. Financial instruments are stocks, bonds, notes, and debentures traded on a national securities exchange, over-the-counter margin stocks as defined in Regulation U (12 CFR, Sections 221.1 et seq), negotiable certificates of deposits, and shares in a money market mutual fund where credit unions may perfect a security interest. This does not include individual mortgages.

RISKS

The primary risk associated with loans secured by readily marketable collateral is that the value of the collateral may decline below the outstanding loan balance. A credit union should ensure that it monitors the market value of any financial instrument held as collateral and takes appropriate action if the value of the financial instrument subsequently declines below a predetermined maximum loan-to-value ratio. Such action may include, but is not limited to, requiring the member to provide additional collateral or reduce the loan balance.

Other risks that should be considered by management include the limited market for closely held or restricted stocks; the price volatility of stocks of smaller or less stable companies; and fluctuations in the value of debt securities as a result of changes in market interest rates.

BOARD-APPROVED WRITTEN POLICIES

In accordance with sound business practices and the requirements of Commission Rule 91.701, before engaging in lending secured by readily marketable collateral, a credit union must establish written policies approved by the board of directors that address the following, as applicable:

1. Types of financial instruments acceptable for collateral purposes and the maximum loan value for each type of instrument;
2. Procedures for safekeeping the financial instruments pledged as collateral;
3. Documentation requirements to establish the credit union's security interest and right to redeem the collateral in the event of default;
4. Procedures for monitoring the value of the financial instruments during the life of the loan, and specific actions that will be taken if the loan balance exceeds the maximum loan value requirement; and
5. Compliance with Federal Reserve Board Regulation U.

FEDERAL RESERVE BOARD REGULATION U

The Federal Reserve Board (FRB) issued Regulation U pursuant to the Securities Exchange Act of 1934 to prevent the excessive use of credit when purchasing or carrying margin securities. The regulation sets out certain requirements for credit unions that extend or maintain credit secured directly or indirectly by margin securities. The reporting requirements and lending restrictions of Regulation U apply only to credit unions required to register.

Registration

Any credit union that extents credit, directly or indirectly secured by margin securities, and that meets either of the following two requirements must register with the Federal Reserve Board:

- Extends margin-stock-secured credit in any calendar quarter equaling $200,000 or more, or
- Maintains margin-stock-secured credit outstanding at any time during a calendar quarter totaling $500,000 or more.

Margin stock consists primarily of equity securities registered on a national securities exchange, such as the New York Stock Exchange or the American Stock Exchange; any over-the-counter security trading in the National Market System; any debt security convertible into a margin stock; and most mutual funds.

Lending Restrictions

Regulation U prohibits credit unions from extending credit in excess of the maximum loan value if the purpose of the credit is to buy or carry margin securities. Credit of this nature is known as a "purpose loan." The maximum loan value of any margin security for a purpose loan is 50 percent of its current market value.

Each purpose credit extended to a member is also subject to the "single credit rule." All purpose credits extended to a member are considered a single credit. Compliance includes aggregation of all collateral.

If the proceeds of a margin-stock-secured loan are for a purpose other than to purchase or carry margin stock, the maximum loan value is the good-faith basis, not to exceed 100 percent of the current fair market value of the collateral. Good-faith basis is the amount that a credit union would be willing to lend without regard to any other assets of the member. Credits of this nature are "non-purpose loans."

The Regulation allows credit unions to permit any withdrawal or substitution of cash or collateral by the member if the withdrawal or substitution would not cause the credit to exceed the maximum loan value of the collateral or increase the amount by which the credit exceeds the maximum loan value of the collateral.

Reporting and Regulatory Requirements

Registered credit unions must file an annual report with the Federal Reserve Bank showing their lending activities secured by margin stock. The report contains the amount of such credit outstanding and extended during a calendar year. Registered credit unions file this report along with a copy of their balance sheet.

Federal Reserve Form FR G-3 entitled "Statement of Purpose for an Extension of Credit Secured by Margin Securities by a Person Subject to Registration Under Regulation U" must also be completed for each credit secured by margin securities. Both the member and the credit union complete the purpose statement for every margin-stock-secured loan extended. The form must be maintained by the credit unions for three years after the credit is paid-off.

Deregistration

A registered credit union may apply to terminate its registration if the credit union has not, during the preceding six calendar months, had more than $200,000 of margin-stock-secured credit outstanding. A credit union is deregistered upon approval of the Federal Reserve Board.

CONCLUSIONS

Managing the risks inherent in loans secured by readily marketable collateral is a complex task. Management must exercise the risk selection, underwriting, credit administration, and portfolio management discipline required to safely manage the risks associated with lending in general. They must also exercise additional diligence to properly identify, measure, and control the unique risks associated with lending secured by readily marketable collateral.

Texas Credit Union Department

REGULATORY BULLETIN

January 22, 2002 RB 2002-01

Guidance on Brokered Certificates of Deposit

BACKGROUND

Recent actions by the Securities and Exchange Commission (SEC) against Robert L. Bentley, Entrust Group, and Bentley Financial Services, Inc. (collectively, Bentley), serve as a warning about fraudulent investment activities. On October 23, 2001, the SEC filed suit against Bentley for suspected securities fraud. Bentley allegedly committed fraud in the sale of securities to financial institutions and to individual investors. Specifically, the SEC alleges that Bentley was representing to investors that they (Bentley) were selling federally-insured certificates of deposit (CDs) when, in fact, they were selling uninsured securities issued by Bentley. The SEC also alleges that Bentley had to attract new investors in order to repay previous investors. The Philadelphia District Court issued a Temporary Restraining Order against Bentley that freezes Bentley's accounts and appoints a receiver to exercise control over Bentley's assets.

PURPOSE

The purpose of this Bulletin is to reemphasize the importance of closely scrutinizing all aspects of a financial transaction, including those perceived to contain little or no risk. In the case of Bentley, investors may have failed to follow fundamental safety and soundness principals. Discussed below are principal areas of concern regarding brokered CD activity.

DEPOSIT BROKERS

CDs have traditionally filled the demand for lower-risk investments; however, declining interest rates have complicated efforts to maintain satisfactory yields. While insured depository institutions directly offer CDs, many brokerage firms and independent salespeople also offer these types of deposits. These individuals and entities, known as "deposit brokers", can sometimes negotiate a higher rate of interest by promising to bring a certain amount of deposits to the institution. The deposit broker then offers these "brokered CDs" to his or her customers.

Many credit unions do not realize that there are no federal or state licensing requirements for deposit brokers. Anyone from a person working alone at home to someone affiliated with a major financial services company can be a deposit broker. This situation places a greater burden upon the potential credit union investor to fully investigate the credentials and qualifications of the deposit broker and the credibility of the transaction.

The burden of investigation and due diligence before committing credit union funds to any investment remains with the credit union's Board of Directors. Credit unions that rely on third parties for the purchase, settlement, or holding of any type of investment should perform routine screening checks into the qualifications and backgrounds of these individuals and entities. One of the initial actions taken before acquiring brokered CDs should involve determining whether the deposit broker is, or is required to be, registered with the SEC and/or the State Securities Board. Registration and certain background information can be obtained from the National Association of Securities Dealers (NASD). Brokers registered with the SEC will be listed in the NASD Central Registration Depository (CRD) and will have a unique number. The CRD can be accessed via the Internet at www.nasdr.com "about your broker", or at NASD Regulation's Public Disclosure toll-free Hotline at (800) 289-9999. Additional information may also be available from the State Securities Board at (512) 305-8300 or www.ssb.state.tx.us, the Secretary of State at (512) 463-5555 or www.sos.state.tx.us, or the local chapter of the Better Business Bureau.

OWNERSHIP

Commission Rule 91.804 requires a credit union that invests funds in a CD to hold such CD in the name of the credit union. This means that the issuing institution's records must indicate the credit union as owner of the investment and not the deposit broker.

FRACTIONALIZED INVESTMENTS

In some instances, brokered CD purchases involve one or more jumbo CDs, which are federally insured, but are resold as "fractionalized" investments using the pool of CDs as collateral. Credit unions may be misled into believing that they are buying the CDs themselves when in fact they are simply making an investment with the broker. At the present time, neither the Texas Finance Code nor the Commission Rules authorize a credit union to purchase this type of security.

SAFEKEEPING

A credit union's purchased investments must be in its possession or held by a board-approved safekeeper under a bailment for hire contract. Any safekeeper used by a credit union must be regulated by either the SEC or a federal or state financial institution regulatory agency.

DOCUMENTATION/VERIFICATION

Brokered CDs may carry unique characteristics. These investments could be "zero coupon" instruments, reflect a long-term maturity, contain a "call" provision benefiting the issuer, and/or may be quoted in simple interest rates. Unscrupulous brokers attempt to cover these undesirable features by omitting certain information, using small print, or even offering to repurchase the investment to indicate liquidity. Listed below are some of the basic characteristics of a brokered CD that should be determined through documented confirmation or verification with the issuer:

> **Maturity Date –** Credit unions should confirm the maturity date and require verification in writing.
>
> **Call Feature(s) –** Callable CDs give the issuing institution the right to terminate or "call" or redeem the CD after a set period of time. The call is established for the benefit of the issuer and mitigates the issuer's exposure to interest rate risk.
>
> **Interest Rate** – Credit unions should require a disclosure statement that specifies the interest rate and whether it is fixed or variable. Interest rates should be thoroughly analyzed and understood. Decisions between investment options are difficult to analyze if yields are not comparable. Bond equivalent yield is the industry convention for comparing yields and should be adopted by your credit union.

BOARD-APPROVED WRITTEN POLICIES

The credit union's Board of Directors should approve comprehensive policies and procedures regarding the use of brokered CDs. Investment decisions based solely on the representations of broker dealers or any third party can be dangerous. Management should be required to verify pertinent information about potential investments in brokered CDs and execute verification procedures during the process. On an ongoing basis, the credit union's audit programs should include a positive direct verification of these investments.

The Board should also establish limits on the volume and types of investments that will be negotiated with each deposit broker. Such parameters are especially important when the investment is other than direct ownership and/or the brokered CD contains unique characteristics.

CONCLUSIONS

The use of brokered CDs can be beneficial if these types of investments are fully understood and managed within a well define plan that conforms to the credit union's asset/liability goals and objectives. During the examination process, Department examiners will review management's policies, procedures, and practices regarding brokered CDs.

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Texas Credit Union Department

REGULATORY BULLETIN

March 12, 2002 RB 2002-02

Internal Controls

INTRODUCTION

Credit unions facing increased competition often consider implementing new strategies including cutting costs, offering different products, and pursuing other activities that have higher yields. While the Department recognizes that credit unions must adapt to changing business conditions, we want to remind management that effective internal control is a foundation for the safe and sound operations of a credit union.

Internal control is a process, brought about by a credit union's board of directors, management, and other personnel, designed to provide reasonable assurance that the credit union will achieve certain internal control objectives. These include efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and rules. Internal control consists of five components that are a part of the management process; control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components is essential to achieving the internal control objectives.

The board of directors and senior executive staff of a credit union are responsible for ensuring that the system of internal control operates effectively. The board may delegate certain duties to others within the credit union or to outside parties; however, the board in delegating such duties is not relieved from the responsibility for ensuring that prudent internal controls are in place. Audits by public accountants and examinations by the Department will continue to place greater emphasis on evaluating the appropriateness of the processes in place, and less reliance on transaction testing.

REGULATORY CONCERNS

The Department is in the process of revising its examination program to a more risk-focused program. The changes will enable the Department to concentrate its resources in areas that present the most risk to the system and to spend less effort in areas of low risk. The risk -focused approach will entail many changes to our examination and supervisory program. There will also be increased emphasis on internal controls and due diligence by credit union management. Examiners will spend more of their time reviewing management's ability to identify, measure, monitor, and control risks in the credit union. Therefore, it is the Department's expectation that management and the board of directors will continue to implement and support effective internal controls appropriate to the size of the credit union, its nature, and scope of activities.

DIRECTOR RESPONSIBILITIES

The board of directors has the primary responsibility of establishing and maintaining an adequate and effective system of internal control. The board is also responsible for approving and periodically reviewing the overall business strategy and significant policies of the credit union, as well as understanding the major risks the institution takes. The board should set acceptable levels for these risks, and ensure that senior management takes the required steps to identify, measure, monitor, and control these risks. To remain effective in the dynamic and ever broadening environment that credit unions operate in, the board of directors must periodically review and update the internal control system.

An active board sets the institution's control consciousness. The following parameters determine effectiveness:

- The extent of its involvement in and its scrutiny of the credit union's activities.
- The ability to take appropriate actions.
- The degree to which the board asks difficult questions and pursues the answers with management.

INTERNAL CONTROL COMPONENTS

The Auditing Standard Board's Statement of Auditing Standard (SAS) No. 78 provides guidance on the independent auditor's consideration of an entity's internal control in and audit of financial statements in accordance with Generally Accepted Auditing Standards. SAS No. 78 recognizes the definition and description of internal control contained in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report, and provides an overview of the framework and evaluation tools needed for a strong system of internal control. The Department encourages credit union management and boards of directors to consider SAS No. 78, or other recognized standards in developing and maintaining an effective system of internal control.

SAS No. 78 consists of five interrelated components derived from the way management runs a business, and integrated with the management process. The components are:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

ASSESSING CONTROL RISK

Under SAS No. 78 control risk is the risk that the credit union's internal control system will not prevent or detect on a timely basis a material misstatement. Assessing control risk is the process of evaluating the design and operating effectiveness of a credit union's internal control.

The Control Environment

The effectiveness of internal controls rests with the people of the organization who create, administer, and monitor them. Integrity and ethical values are essential elements of a sound foundation for all other components of internal control. The commitment for effective control environment rests at the top.

Risk Assessment

All credit unions, regardless of size, encounter risk in their organizations. The ability to identify and manage these risks will affect a credit union's ability to survive in a competitive market. In order to assess risk, management must first set objectives to quantify the amount of risk they can prudently accept.

Risks relevant to financial reporting include external and internal events, and circumstances that may adversely affect a credit union's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such risk can arise or change due to the following circumstances:

- Operating environment changes
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New lines, products, or activities
- Corporate restructuring
- Accounting pronouncements

Control Activities

Control activities are the policies and procedures that help ensure management carries out its directives. Control activities should assure accountability in the credit union's operations, financial reporting, and compliance areas.

Information and Communication Systems

Management must identify, capture, and communicate information to enable people to carry out their responsibilities. Internally generated data, along with external events, activities, and conditions is necessary for a business to make informed decisions. Management must design ways to downstream messages from the top, as well as upstream significant information.

An information system should also provide sufficient detail to properly classify the transaction for financial reporting, and measure the value of the transactions in a manner that permits recording the proper monetary value in the financial statement in accordance with Generally Accepted Accounting Principles (GAAP).

Monitoring

Monitoring is a process that assesses the quality of the internal control performance over time. Management must build ongoing monitoring activities into the normal recurring activities of their institution, and monitor the internal control system on an ongoing basis to ensure that the system continues to be relevant and addresses new risks.

LIMITATIONS OF INTERNAL CONTROL

When operating under the best of conditions, internal control provides only reasonable assurance to management and the board of directors that the institution is achieving its objectives. Reasonable assurances do not imply that the internal control systems will never fail. Many factors, individually and collectively, serve to provide strength to the concept of reasonable assurance. However, because of inherent limitations, management has no guarantee that, for example, an uncontrollable event, a mistake, or improper reporting incident could never occur. Thus, it is possible for the best internal control system to fail. The limitations inherent to internal control are:

- Judgment
- Breakdowns
- Management override
- Collusion
- Fraud
- Cost versus benefits

Judgment

Human judgment can limit the effectiveness of internal controls. Management makes business decisions based on the information at hand and under time constraints. With hindsight, these decisions may produce less than desirable results.

Breakdowns

The best internal control system can experience any of the following breakdowns:

- Misunderstood instructions
- Careless employees
- Inadequate training
- Time limitations

Management Override

Management override means management overrules prescribed policies or procedures for illegitimate purposes with the intent of personal gain or to enhance the presentation of financial statements. Override practices include deliberate misrepresentations.

Do not confuse management override with management intervention. Management intervention represents management's actions that depart from prescribed policies for legitimate purposes. At times, management intervention is necessary to deal with nonrecurring and nonstandard transactions or events, that otherwise might be handled inappropriately by the control system.

Collusion

When two or more individuals act in concert to perpetrate and conceal an action from detection, they can circumvent any system of internal control.

Fraud

Fraud is a broad legal concept, and involves intentional illegal acts that generally cause misstatement in the financial statements. Management bears the primary responsibility for detecting fraud. Internal control systems implementation is part of management's fiduciary responsibilities to prevent fraud and abuse by insiders.

Cost versus Benefits

The challenge is to find the right balance between the proper controls and the costs to design and implement internal controls. Excessive control is costly and counterproductive. Too few controls present undue risks.

OUTSOURCING RISKS

Credit unions rely increasingly on services provided by third parties to support a wide range of activities. Outsourcing to third parties may help manage costs, improve and expand services offered, and obtain expertise not internally available. At the same time, reduced operational control over outsourced activities may expose credit unions to additional risks.

Outsourcing involves some of the same operational risks that arise when a credit union performs a function internally. Such risks include the following:

- Threats to the availability of systems used to support member transactions.
- The integrity or security of member account information.
- The integrity of risk management information systems.

Under outsourcing arrangements, however, the risk management measures commonly used to address these risks, such as internal controls, are generally under the direct control of the service provider, rather than the credit union that bears the risk of financial loss, damage to reputation, or other adverse consequences.

The Department expects credit unions to ensure that controls over outsourced activities are equivalent to that the institution would implement if they conducted the activity internally. The credit union's board of directors and senior management should understand the key risks associated with the use of service providers. They should ensure that an appropriate oversight program is in place to monitor each service provider's controls, condition, and performance.

CONCLUSION

No system of internal controls is foolproof; however, strong internal control systems can reduce risk and minimize loss. We encourage all credit unions to carefully review and, where appropriate, strengthen their internal control systems.

Texas Credit Union Department

REGULATORY BULLETIN

November 8, 2002 RB 2002-03

Fiduciary Powers/Trust Activities

INTRODUCTION

The offering of limited fiduciary services has long been regarded as an ancillary service for credit unions. However, in recent years a number of forces have combined, with the result that fiduciary services are becoming a more dynamic and sought-after product line. In Texas, population trends have been a significant factor as the large post-World War II "baby boom" generation matures and accumulates wealth. The large size and influence of this group has created more emphasis on wealth management and transfer. While this has presented credit unions with more opportunities, it has also presented substantive challenges to credit unions as they try to offer trust services in a manner that is safe and sound.

While the Department may prefer that certain trust activities be conducted within a credit union service organization (CUSO), it is supportive of credit union involvement in trust services that are legal, prudent, and consistent with sound credit union principles. However, due to the more complicated nature and level of risk associated with certain trust services, it is necessary that the credit union's board of directors and management ensure that sound policies and procedures are in place to govern its involvement in these activities.

This Bulletin was developed to provide guidance to credit unions on various issues associated with trust services. Any credit union involved in trust services should address these issues in a manner appropriate to the nature and extent of activities conducted within its organization.

FIDUCIARY RISKS

Risk associated with a credit union's exercise of its fiduciary powers can be generally categorized as resulting from:

Reputation Risk – where the risk to the credit union arises from negative public opinion. Negative publicity can be caused by many factors, including failure to address and manage the other risks addressed below. Increased reputation risk can affect the credit union's ability to establish member relationships and/or service existing relationships.

Strategic Risk – where the risk to the credit union arises from improper business planning, poor decision-making, failure to implement decisions, or inadequate responses to changes in the industry. This risk focuses on management's ability to develop sound business strategic goals, implement processes compatible with these goals, and deploy appropriate resources to achieve them. Management should implement policies, procedures, and practices to ensure that the credit union's fiduciary activities are conducted in compliance with applicable law. Management should also ensure that appropriate risk assessment and monitoring systems are in place to identify and control risks resulting from fiduciary activities.

Transaction/Operational Risk – where the risk to a credit union is unacceptable operating losses or legal liability arising from substandard policies or practices. This may include inadequate controls and other safeguards over fiduciary assets, erroneous recordkeeping, excessive costs, inadequate revenues, fraud, embezzlement, or other similar deficiencies in operations. Transaction risk is inherent in each product and service offered.

Compliance/Legal Risk – where the risk to a credit union is exposure and legal liability arising from noncompliance with applicable law, the trust instrument or other document establishing the fiduciary relationship, sound fiduciary principles, internal policies and procedures, or the failure to identify and manage conflicts of interest and ethical standards.

Financial Risks – where the risks are inherent in the fiduciary activities of the credit union, especially where the institution has discretion over account assets or provides investment management services for a fee. Financial risk has an adverse affect on the value of account portfolios, which could further impact the capital levels of the credit union. Financial risk includes: 1) credit risk, the risk to the value of the account portfolio arising from failure to meet the terms of any contract; 2) price risk, the risk to the value of the account portfolio arising from changes in the value of the underlying financial instrument; 3) liquidity risk, the risk to the value of the account portfolio arising from the accounts inability to meet obligations and achieve account objectives; and 4) interest rate risk, the risk to the value of the account portfolio arising from movements in interest rates.

The earnings and capital of credit unions with significant reliance on trust revenues may be adversely affected when financial markets experience a significant and sustained downturn. Since trust departments are dependent on transaction volumes and market values of assets under management; revenue, and hence earnings, may decline substantially during periods of adverse market movements. Credit unions could ultimately find themselves funding trust department capital when unfavorable market conditions exist.

Further, risks associated with fiduciary activities can be distinguished in part from those associated with commercial activities, in that the potential liability from fiduciary activities can exist for the life of the account, through successive generations of beneficiaries. Conversely, commercial risk lasts only as long as the commercial transaction lasts. In addition, fiduciary liability is not always as easily quantifiable as commercial liability, in that fiduciary liability can increase or decrease based on the market value of the account assets in question.

APPLICABLE LAW

Applicable law generally consists of common law and statutory law. The courts develop common law. Statutory law can consist of statutes adopted by legislative bodies or rules and regulations adopted by state or federal agencies. In Texas, trustees must be cognizant of and deal with the Texas Trust Code as it supplements and, in some cases, revises the common law. In addition, state and federal credit union and banking regulators may adopt various rules and regulations applicable to trustees. Consequently, it is most important that credit unions not only have competent legal counsel readily available to advise them, but also make sure that any staff or credit union officials involved in fiduciary activities are sufficiently educated in the vagaries of applicable law.

FIDUCIARY LIABILITIES

A credit union acting as a fiduciary can be held liable if it:

- Violates any applicable law;
- Does not comply with the terms of the will, trust or pension plan or, in some instances, court rulings and orders; or
- Fails to properly discharge any of its duties or responsibilities or abuses any of its powers.

Any present or future beneficiary, other interested person (as defined in the Texas Trust Code), or a co-fiduciary, may be able to institute legal action against a fiduciary. The remedies that can be sought are several, depending upon the alleged violation but commonly include compelling the fiduciary to perform its duties; compelling the fiduciary to provide an accounting of the managed assets; enjoining the fiduciary from committing a further violation; compelling the fiduciary to make restitution for the violation; removing the fiduciary; and/or disallowing the fiduciary from ever serving in another fiduciary capacity. If found liable, the fiduciary is said to have committed a "breach of trust." If the fiduciary is found to have committed a breach of trust, it will be held liable: for any loss or depreciation of the account that results from its actions or inactions; for any profit made by the fiduciary through its actions; or any profit that would have accrued to the account if there had been no breach. The amount by which the fiduciary is required, by a court of law, to pay the "breached" fiduciary account is known as a "surcharge." Attorney's fees will also be awarded and, in some severe cases, punitive damages are possible.

While there are numerous sources of fiduciary liability, the most significant ones generally involve:

Imprudent management of account investments, including: the purchase or sale of speculative securities such as naked put options or fixed income securities that are rated below an investment grade quality; unreasonable retention of nonincome producing assets such as vacant land and/or a noninterest bearing note; undue concentrations and/or failure to properly diversify account assets, such as investing a majority of the account assets in one type of security; or imprudently investing in affiliated products.

Failure to manage cash, including: leaving large amounts of cash uninvested for an unreasonable length of time and/or allowing or creating overdrafts.

Imprudently engaging in self dealing or other conflicts of interest, including: making investment decisions not in accordance with applicable law, particularly investments such as the purchase of credit union's own mortgages; investing in corporations in which directors have an interest; engaging in insider trading; or imprudently using an affiliate's investment products or brokerage service.

Failure to properly manage real property, including: the failure to insure the property, the failure to pay taxes, or the failure to maintain properties in proper repair.

Mismanagement of an account, including: making improper or unauthorized distributions; the failure to make timely court accountings or tax filings; and the improper allocation of principal and/or income receipts.

Improper delegation of duties, including: allowing or delegating the investment discretion to someone such as an investment advisor without appropriate oversight and the failure to supervise acts of agents such as property managers.

Taking actions without approval, including: those actions that require the consent of beneficiaries, prior approval of the grantor or co-fiduciaries or from a local court with jurisdiction.

CURRENT LIABILITY ENVIRONMENT

The trust business continues to come under increasing scrutiny due to the applicability of certain federal and/or state laws. For example, the Employee Retirement Income Security Act of 1974 (ERISA) generally imposes the highest standard of fiduciary liability on fiduciaries administering assets of employee benefit plans. As another example, environmental liability issues are a matter of increasing concern due to the potential risk and substantial liability that may arise in connection with the enforcement of state and federal laws and regulations applicable to real estate interest held by trust accounts.

The trust industry itself continues to undergo dramatic change. Fiduciary services were historically offered by financial institutions in order to provide full-service financial services and were thus viewed as a "loss-leader." While the motivation has not disappeared, the trust industry has largely shifted to a fee-based, profit-center type of industry with increased competition. This increased competition has increased the potential for exposure, in that service might be sacrificed to cut expenses. Due to cost cutting measures, risk from operations-related areas such as clerical and processing functions has increased.

Another reason for increased loss potential is that society itself has changed. Members are more informed and sophisticated regarding a credit union's responsibilities and are more apt to initiate legal actions. Illustrative of the new attitude is the increase in the number of class-action suits being brought against financial institutions by trust account beneficiaries.

RISK MANAGEMENT

Risk management plays an increasing role in trust departments due in large measure to the risks and liabilities discussed above. Standards of fiduciary responsibility and potential liability continue to evolve under new legislation and legal theories. Management decisions, whether they are legal, operational, or administrative in nature, seldom have predictable outcome. Thus, each decision involves some degree of risk or uncertainty. Credit unions should consider risk, and the management of risk, in developing its organizational structure and as part of the decision-making processes. The Department strongly encourages credit unions to develop strong risk management programs to identify and control fiduciary risks.

Effective risk management guards against liability that can result from lawsuits or poor administrative practices and/or supervision. A risk management program identifies those areas where there is potential for exposure and then attempts to quantify the risks associated with that area or practice. Through such a program, credit unions have identifiable criteria by which to evaluate the consequences of a decision. Thus, for example, the degree of risk associated with offering a new trust service may play a significant role in deciding whether or not to offer that service. An effective risk management program can act as an early warning system to anticipate and, hopefully, prevent potential problems from arising that may result in unanticipated loss to the credit union.

RESPONSIBILITIES OF THE BOARD OF DIRECTORS

The board of directors is ultimately responsible for all aspects of the credit union's trust duties. Directors are responsible for retaining and performing general supervision over the exercise of fiduciary powers. In discharging its authority, the board of directors may delegate duties and responsibilities to such committee(s), director(s), officer(s), or employee(s) as it deems appropriate. However, the board retains ultimate responsibility for all delegated matters and must maintain the proper degree of control and supervision over those it has empowered.

POLICIES, PROCEDURES AND INTERNAL CONTROLS

The board of directors should formulate and implement suitable policies, procedures, and internal controls (collectively referred to below as “policies”) to promote sound trust administration. Comprehensive, well-developed policies, assuming they are followed, monitored, and enforced, are one of the most effective methods of promoting operating efficiency, ensuring compliance with laws and fiduciary principles and deterring losses. The scope and detail of policies adopted by the board of directors for the trust department should take into account the credit union’s size, complexity and trust risk profile. While the need for and content of policies will therefore vary between credit unions, written policies should ordinarily be in place for the following areas:

Federal Securities Laws: Written policies and procedures should ensure that any decision or recommendation to purchase or sell any security is not made by fiduciary officers and employees using material inside information.

Conflict of Interest: Polices should be established to cover those areas where the interest of the fiduciary account might conflict with those of the credit union itself (i.e. in its role as lender), it directors, employees or its affiliates.

Asset Management: Policies should be established to demonstrate compliance with applicable state “prudent investor” laws or applicable federal law such as ERISA when the credit union makes investment decisions for trust accounts. Investment policies should exist that are designed to promote preservation of principal, diversification of portfolios, establishment of individual account investment objectives, production of income (including prompt investment of income and principal cash), and to prevent speculation. The board should also ensure that any delegation of investment activity (e.g., investment advisory services) is pursuant to a written agreement, whereby the credit union retains ultimate investment oversight and responsibility.

Account Administration: Policies should be established to assure that all trust accounts are administered in a consistent manner and in accordance with the terms of the governing instrument and applicable law. Examples of such policies include, acceptance of accounts; account set-up; account reviews; overall administration; and account termination procedures.

Operations: Policies should be established to assure the integrity and accountability of the trust department’s systems and internal controls. Examples of such policies include, storage and handling of assets; separation of duties; processing and reconcilement of transactions; document filing and maintenance; outsourcing; and standards for information technology systems.

Personnel: Policies should be established regarding the appropriate size and qualifications of staff, organizational structure, and employee ethics. The latter policy should address the acceptance of gratuities and bequest from members or other interested parties and any personal services rendered, benefits gained and/or influences exerted by the employee to or from the member.

Business Development and Profitability: Policies should address the nature and type of the trust business to be solicited, fees to be charged, marketing strategies, and the overall goals and objectives of the credit union in offering and providing trust products and services.

CONCLUSIONS

Credit unions should recognize the additional risk inherent in trust services and determine if these risks are acceptable and controllable given the credit union's staff, financial condition, size, and level of capital.

The minimum requirements to provide for sound credit union practices in the operation of a trust department and to provide safeguards for the protection of members, fiduciary beneficiaries, creditors, and the public, should include:

- Involvement by the board of directors in providing for the establishment and continuing operation of a trust department;
- Operation of the trust department separate and apart from every other activity of the credit union, with trust assets separated from other assets owned by the credit union, and the assets of each trust account separated from assets of every other trust account; and
- Maintenance of separate books and records for the trust department in sufficient detail to properly reflect all trust department activities.

Although authorized to delegate duties, the board continues to be responsible for the oversight of all trust activities. Sufficient reporting and monitoring procedures should be established to fulfill this responsibility. The board of directors, by proper resolution included in its minutes should:

1. Designate an officer, qualified and competent, to be responsible for and administer the activities of the trust department. In addition, the board should define the officer's duties.

2. Name a trust committee consisting of at least two directors to be responsible for and supervise the activities of the trust department.

The trust committee should:

(a) Meet at least quarterly, and more frequently if considered necessary and prudent to fulfill its supervisory responsibilities;
(b) Approve and document the opening of all new trust department accounts; all purchases and sales, and changes in, trust assets; and the closing of trust accounts;
(c) Provide for a comprehensive review of all new accounts for which the credit union has investment responsibility promptly following acceptance;
(d) Provide for a review of each trust department account at least once during each calendar year. The scope, frequency, and level of review should be addressed in appropriate written policies which give consideration to the department's fiduciary responsibilities, type and size of account, and other relevant factors. (Generally, discretionary account reviews should cover both administration of the account and suitability of the account's investment, and non-discretionary account reviews should address account administration);
(e) Keep comprehensive minutes of meetings held and actions taken;
(f) Make periodic reports to the board of its actions; and
(g) Establish and maintain a continuing education program for members of the committee and appropriate credit union staff.

3. Provide comprehensive written policies which address all important areas of trust department activities.

4. Provide competent legal counsel to review trust instruments or other fiduciary related documents prior to acceptance by the credit union and advise trust officers and the trust committee on legal matter pertaining to fiduciary activities.

5. Provide for adequate internal controls including appropriate controls over trust assets.

6. Provide for an adequate audit of all fiduciary activities, annually. The findings of the audit, including actions taken as a result of the audit, should be recorded in its minutes.

7. Receive reports from the trust committee and record actions taken in its minutes.

8. Review the examination reports of the trust department and record actions taken in its minutes.

Texas Credit Union Department

REGULATORY BULLETIN

December 2, 2002 RB 2002-04

Board and Directorship Responsibilities

INTRODUCTION

Corporate governance in this country has been the target of a fair amount of criticism in recent months – much of it justified. This Bulletin, therefore, is intended to clarify the Department's position on the duties and responsibilities of credit union directors. It covers the basic principles of a credit union board's function and responsibilities, but it is not all-inclusive. It also highlights the areas that the Department perceives to be minimal requirements for the functioning of a credit union board of directors.

Section 5.09 of the credit union's bylaws enumerates the duties and powers of directors. In particular, this section provides that the board of directors has the authority and responsibility for the general direction and control of the business affairs, funds and records of the credit union and is responsible for its safety and soundness. In addition, as directed by Title 2, Chapter 22 of the Business Organizations Code, directors must discharge their duties in good faith, with ordinary care, and in a manner the directors reasonably believe is in the best interest of the credit union. Therefore, directors must have a general knowledge of the daily operation of the credit union, and must act in good faith and exercise due diligence in performing their duties. Due diligence includes asking questions and requesting additional information in order to be fully informed and understand the actions the board takes as well as the potential ramifications or risks of the actions. Directors are also accountable to the credit union's membership and its regulators.

Because of the nature of the credit union business, directors have been placed in a position of trust and honor. Their selection to this position implies the highest confidence of the members in the individual's integrity, business sense and morality, and a person who is capable of fostering the membership trust. The credit union business requires a higher degree of accountability from those who choose to serve as directors. Both statutory and common law have placed the responsibility for credit union management firmly on the members of a credit union's board of directors. The management of the credit union's daily affairs may be delegated to an officer, but delegation of responsibility for consequences resulting from unsound or imprudent policies and practices cannot be transferred.

Revised – November, 2009

Responsible, competent directors are crucial to the success of any financial institution. The job of a credit union director is never stagnant, and each situation provides an opportunity to learn and grow. Serving as a director requires commitment and dedication and the duties must not be taken lightly.

DIRECTORSHIP POLICY

Each board of directors should develop a Directorship Policy that sets requirements and guidelines for directors, and clearly states the board's view of its role in guiding the credit union. The following areas should be addressed in the Directorship Policy. Please note that these are recommended minimums, and should not be considered an inclusive list of characteristics for an effective board.

Attendance. Directors cannot fulfill their responsibilities if they do not attend board meetings on a regular basis. Each director must devote sufficient time and effort to remain informed and aware of issues affecting the credit union.

Compliance. The board must maintain the integrity of the credit union by ensuring compliance with applicable laws and regulations. New or amended legal and regulatory requirements must be understood and properly implemented. Profession counsel should be sought when necessary to ensure that directors and management have an appropriate understanding of legal and regulatory requirements.

Continuity. The board must ensure the credit union remains in sound financial and operational condition over time. Preserving the credit union as a viable institution requires proper board oversight in crucial areas such as strategic planning, capital accumulation, asset quality, liquidity, funds and risk management, and management development and succession.

Hiring and retaining competent management for the credit union is one of the board's most important duties. Appropriate performance standards must be developed for the credit union's president. The president's performance should be formally and objectively reviewed against these standards at least annually. Boards of directors must be willing to take appropriate actions, up to and including removal, when managers lack the competence or integrity to operate the credit union in a safe and sound manner.

Education. Education is crucial to being an effective director. Credit unions operate in a dynamic, highly regulated environment, and the need for informed, competent directors has never been greater. Extensive education resources are available for credit union directors. Ongoing education is essential to ensure that directors understand and appropriately control the risks inherent in operating a depository financial institution.

Revised – November, 2009

Examinations and Audits. The board is responsible for reviewing all reports of examination and audits performed by outside sources and implementing any changes which are necessary to correct the deficiencies contained therein.

Insurance. The board must ensure that the credit union has adequate insurance coverage for contingences, which should receive at least annual review for reaffirmation and possible restructuring.

Integrity. A director must maintain the highest standards of personal conduct. Directors must demonstrate integrity, dedication, and cooperation. Maintaining the confidentiality of credit union business and individual member information is essential.

Internal Control. The board must establish procedures for conducting audits whether it be by a committee of the board or by an outside firm. (Examinations conducted by the Department do not substitute for an audit.)

Leadership. Effective directors use good judgment and work for the best interest of the membership. The board's responsibility is to ensure that adequate policies, procedures, management, and planning are in place; the board should not be led or simply monitor results after the fact. Care should be taken, however, not to assume responsibility for conducting the credit union's daily operations. Conversely, management should not usurp the director's role. The board should direct and management should manage.

Management Information System. The board is responsible for establishing a system whereby the credit union's affairs are presented to them in a manner which will allow reasonable comprehension of the information presented and which presents fairly the credit union's activities.

Policy. Establishing sound policies is one of the board's more important functions. Policies should clearly and concisely state intentions, limitations, and controls that will dictate a specific course of action. Policies should be comprehensive, reduced to writing, approved by the board, and reviewed and revised or reaffirmed at least annually. The board should also make certain that its policies are fully understood and being adhered to by those who are subject to such policies.

Records of Board Action. It is the responsibility of the board to insure that adequate minutes and other records of board actions, including pertinent discussions, dissenting opinions, etc. be maintained.

Removal. Ideally, all credit union directors will be strong representatives for the membership. The policy should, however, discuss necessary actions when directors are not properly fulfilling their responsibilities. Events and circumstances that would warrant removal of a credit union official, as provided by Section 122.055(c) of the Texas Credit Union Act, should be outlined.

Revised – November, 2009

Self Evaluation. The Directorship Policy should be made part of the credit union's overall operating policies, and should be reviewed on a regular basis. Each board of directors should objectively analyze its performance and compliance with the Directorship Policy at least annually.

CONCLUSIONS

It is incumbent on each director to conscientiously work at being a director. No one is immune from potential liability; nevertheless, if honesty and diligence to duty prevails on the credit union's board, the word "liability" should exist only as it relates to the credit union's normal course of business activities.

Texas Credit Union Department

REGULATORY BULLETIN

May 21, 2003 RB 2003-01

Serving Members Affected By Natural Disasters

INTRODUCTION

This bulletin is intended to encourage credit unions to work with members in communities affected by natural disasters. The Department recognizes that effects of such disasters on individuals and businesses are usually temporary, and prudent efforts to alter or adjust payment terms or to grant new loans to members in affected areas should not be criticized by examiners.

POLICY

One of the principal objectives of the supervision by risk approach is to achieve an accurate assessment of a credit union's risk management practices. The assessment includes an evaluation of how a credit union identifies, monitors, manages, and controls risks when a segment of its loan portfolio is affected by external factors such as a natural disaster. This Department believes that a proactive approach is best and highly recommends that each credit union develop a Disaster Recovery Plan, which details policies and procedures the credit union will follow in the event of a natural disaster which directly affects the credit union facility and/or its members. Please keep in mind that the officer in charge of a credit union is permitted to close the credit union in the event of an emergency in accordance with TAC Section 91.5001.

The Department recognizes that the efforts of credit unions to work with members in communities under stress, if conducted in a reasonable manner, are consistent with the principles of safety and soundness and in the public interest. It is the Department's policy not to criticize reasonable efforts to alter or adjust payment terms or to grant new loans to members affected by disasters.

Credit unions may, as part of effective risk management, choose to work with members by extending the terms of repayment or otherwise restructuring the member's debt obligations. Such cooperative efforts can ease pressures on troubled members, improve their capacity to service debt, and strengthen the credit union's ability to collect on its loans. Credit unions may also ease credit-extension terms for new loans to certain members, consistent with prudent credit union and risk management practices. This will help such members recover their financial strength and place them in a better position to service their debts.

Credit unions operating in or extending services near an affected area may also want to consider temporarily waiving:

- late payment charges as well as penalties for share drafts returned because of insufficient funds where it appears that such late payments and NSF conditions resulted from delays beyond the members control; and
- penalties for early withdrawal of savings in circumstances where the member has a demonstrable need for the funds resulting from the disaster.

CONCLUSIONS

With proper risk controls and management oversight, these steps can contribute to the health of the local community and serve the long-term interest of the credit union as well. Consistent with long-standing Department practice, such efforts by credit unions will not be subject to criticism, if carried out in a prudent manner.

Texas Credit Union Department

REGULATORY BULLETIN

April 5, 2004 RB 2004-01

Annual Audit and Account Verification

BACKGROUND

The board of directors and senior management of a credit union are responsible for ensuring that the institution operates in a safe and sound manner. To achieve this goal and meet the requirements of Commission Rule 91.515, the credit union must maintain effective systems and internal controls to produce reliable and accurate financial reports.

Accurate financial reporting is essential to a credit union's safety and soundness for numerous reasons. First, accurate financial information enables the board and management to effectively manage the credit union's risk and make sound business decisions. In addition, credit unions are required by law to provide accurate and timely financial reports (e.g., 5300 Call Reports) to the Department. These reports serve an important role in the Department's risk-focused examination program by contributing to our pre-examination planning, off-site monitoring programs, and assessment of a credit union's net worth adequacy and financial strength.

To help ensure accurate and reliable financial reporting, Section 122.102 of the Finance Code and Commission Rule 91.516 require the board of directors of each credit union to obtain an audit annually and cause a verification of accounts to be performed, at least once every two years. The annual audit and verification should be important components of a credit union's overall risk management process. For example, the annual audit provides management and the board of directors with an independent and objective view of the reliability of the credit union's financial statements and the adequacy of its financial internal controls. Additionally, an effective audit program contributes to the efficiency of the Department's risk-focused examination process. By considering the significant risk areas of a credit union, an effective audit program may reduce the examination time the Department spends in such areas. Moreover, it can improve the safety and soundness of a credit union substantially and lessen the risk the institution poses to the share insurance fund administered by the NCUA.

ANNUAL AUDIT

Responsibilities of the Board of Directors

Each credit union should have an audit function that is appropriate to its size and the nature, scope, and complexity of its activities. The board of directors of a credit union is responsible for determining how to best obtain reasonable assurance that the institution's financial statements and regulatory reports are reliably prepared. In this regard, the board is also responsible for ensuring that its annual audit is appropriate for the credit union, and adequately addresses the financial reporting aspects of the significant risk areas and any other areas of concern of the institution's business. The reasons supporting the decision for obtaining a particular type of audit should be recorded in the board's minutes.

It is the responsibility of the board to carefully consider the extent of auditing that will effectively monitor the risks after taking into account the audit functions costs and benefits. For institutions that are large or have complex operations, the benefits derived from an annual audit performed by an independent public accountant likely outweigh the cost. For small institutions with less complex operations, however, these costs may outweigh the benefits.

The board of directors is also responsible for selecting the persons or the firm that will carry out the audit functions. An engagement letter that details the purpose and scope of the auditing work to be performed and reported must evidence audits completed by an independent auditor. In order to preserve the independence and objectivity of the audit, the board must contract directly with the selected auditor. It is not appropriate for the board to delegate this responsibility to the credit union's president or other employees.

Audit Committee

To help ensure the adequacy of the annual audit, the board of directors may designate persons to constitute an audit committee, which shall have and may exercise such powers as the board determines and specifies. Although the board may delegate to the audit committee the performance of certain duties, the board is not relieved from the responsibility for the performance of such duties.

Basic Characteristics

The annual audit should provide the board of directors with information about the credit union's financial reporting risk areas, e.g. the institution's internal control over financial reporting, the accuracy of its recording transactions, and the completeness of its financial reports prepared in accordance with Generally Accepted Accounting Principles (GAAP).

The board or audit committee of each institution should, at least annually, review the risks inherent in the credit union's particular activities to determine the scope of its annual audit. For most credit unions, the lending and investment activities present the most significant risks that affect financial reporting. Thus, the annual audit should include specific procedures designed to test the risks associated with the loan and investment portfolios. This includes testing of internal control over financial reporting, such as the process to determine the adequacy of the allowance for loan and lease losses and whether this process is adequately documented, and consistently applied when analyzing the credit union's loan portfolio.

Types of Audits

Although the Department considers an audit of a credit union's financial statements to be the preferred type of annual audit, it recognizes that, depending on its size, a credit union's audit responsibilities may be fulfilled by other engagements. Specifically, a credit union having total assets of $500 million or greater is required to obtain an annual audit of its financial statements performed by an independent public accountant who is licensed by the State of Texas. For those credit unions with total assets of less than $500 million, the Board of Directors may select a financial statement audit, a balance sheet audit, a report on examination of internal control over financial reporting, or an audit per NCUA's Supervisory Committee Guide (12 CFR, Chapter VII, Part 715), as it deems appropriate.

Financial Statement Audit by an Independent Public Accountant. The Department encourages credit unions to have an audit performed in accordance with generally accepted auditing standards (GAAS) by an independent person who is licensed by the State of Texas. The object of a financial statement audit is to express an opinion as to whether the financial statements of the credit union present fairly, in all material respects, the financial position and the results of its operations and its cash flows in conformity with GAAP. In addition, an audit may provide recommendations for management in carrying out its control responsibilities. For example, an audit may provide management with guidance on establishing or improving accounting and operating policies, and include recommendations on internal controls necessary to ensure the fair presentation of the financial statements.

Balance Sheet Audit Performed by an Independent Public Accountant. With this program the credit union engages an independent public accountant to examine and report only on the institution's assets, liabilities, and equity for the purpose of opining on the fairness of the presentation of the balance sheet. As with the audit of the financial statements, this audit is performed in accordance with GAAS. The cost of a balance sheet audit is likely to be less than a financial statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the credit union's income statement, statement of changes in equity capital, or statement of cash flows.

Reporting by an Independent Public Accountant on an Institution's Internal Control Structure over Financial Reporting. Another auditing program is an independent public accountant's examination and report on management's assertion on the effectiveness of the credit union's internal control over financial reporting with a concentration in high-risk areas, such as lending activity, investment activity, and cash handling and deposit taking activity. For a smaller credit union with less complex operations, this type of engagement is likely to be less costly than an audit of its financial statements or its balance sheet and normally provides recommendations for improving internal control, including suggestions for compensating controls, to mitigate the risks due to staffing and resource limitations. This type of engagement is performed under generally accepted standards for attestation engagements (GASAE).

Audit per NCUA's Supervisory Committee Guide. With this program the credit union causes an audit to be performed by a qualified person or committee in accordance with the procedures prescribed in NCUA's *Supervisory Committee Guide*. NCUA's Guide does not attempt to address every possible situation that may be encountered, nor does it contend that many of the procedures described are the only ones that can be used. Procedures appropriate for one credit union may vary widely from those of another credit union. Therefore, any person using this Guide must plan and carry out the duties in a manner consistent with and responsive to the particular situation and needs of the credit union. Qualified persons who are not licensed by the State of Texas cannot provide assurance services under this program.

Timing

A credit union is required to obtain an annual audit which occurs at least once every calendar year and must cover the period elapsed since the last audit period. The preferable time to schedule the performance of an audit is as of the institution's fiscal year-end.

Access to Information

A credit union should provide its auditor with access to all examination reports and written communication between the credit union and the Department since the last auditing activity. The credit union should also provide access to any letters of understanding, supervisory agreements, or administrative orders initiated or taken by the Department. The auditor must maintain the confidentiality of examination reports and other confidential supervisory information. In addition, an outside auditor should agree in the engagement letter to grant examiners access to all of the workpapers and other materials pertaining to the credit union that were prepared in the course of performing the audit.

Reports

Upon receipt of the written report of a financial statement audit or other audit program, the Board or Audit Committee must verify that the audit was performed and reported in accordance with the terms of the engagement letter. The Board shall review the results of the audit and take appropriate action to rectify any deficiencies noted. A summary of the result of the audit shall be provided to the members of the credit union orally or in writing at the next annual meeting.

Adequacy of Audit Function

If an examiner concludes that a credit union's audit function does not sufficiently meet the institution's audit needs, or is otherwise inadequate, he or she will bring these matters to the attention of senior management and the board of directors. If these discussions do not resolve the examiner's concerns, he or she will discuss the weaknesses with appropriate Department staff in order to determine the appropriate action the Department should take to ensure that the credit union corrects the deficiencies. These actions may include compelling a credit union to have a new audit performed by an independent public accountant who is acceptable to the Department.

ACCOUNT VERIFICATION

The board of directors is also responsible for causing the shares, deposits, and loan accounts to be verified against the records of the credit union. The credit union must verify accounts that are currently outstanding, as well as those that members have closed since the prior closed account verification. The verification must be performed by a qualified person or committee in accordance with the procedures prescribed in Section 715.8 of the NCUA's Rules and Regulations (12 CFR, Chapter VII, Part 715). The purpose of the verification is to detect errors, and it is also a good control to prevent fraud.

Mailing Verifications

Account verification means requesting that members respond if the activity or balance on their statements is not accurate. The qualified person or committee may mail verifications to the members by either independently mailing a confirmation letter to the members, or by mailing the members' statement of account along with a verification notice.

Basic Controls

The qualified person or committee conducting the verification must ensure, at a minimum, the following controls:

1. Be sure to use an independent address. This is true of both the return address on the envelope, and the contact person for problems.
2. Do not use management or operating staff to prepare and mail the forms, or select the sample. In some cases, the qualified person or committee may require staff assistance. If so, staff should be well supervised.
3. Select a date for the verification that is unknown to staff. Conducting the verification on a surprise basis allows little time to adjust or manipulate records prior to the verification.
4. All information that is needed for the verification should be gathered at one time. If feasible, control should be maintained over all records while conducting the verification.

Timing

The date of the verification is at the Board's discretion, as long as one is completed at least once every two years, or as otherwise, specified in the credit union's bylaws. The Board may want to consider completing the verification with the annual audit.

Retention of Records

The qualified person or committee must retain the records of each verification of members' accounts until it completes the next verification of members' accounts.

CONCLUSION

The annual audit and account verification complement the Department's supervisory process and the credit union's internal auditing program by identifying or further clarifying issues of potential concern or exposure. These programs also can greatly assist management in taking corrective action, particularly when weaknesses are detected in internal control or management information systems affecting financial reporting.

Texas Credit Union Department

REGULATORY BULLETIN

November 18, 2005 RB 2005-01

Bank Secrecy Act (BSA) Compliance

BACKGROUND

In October 2004, the Financial Crimes Enforcement Network (FinCEN) entered into an agreement with the federal banking regulators, including the National Credit Union Administration (NCUA), concerning the reporting of significant BSA violations. The agreement went effect on December 1, 2004 and all state credit union regulators will be bound to similar reporting requirements. Currently, FinCEN is negotiating with the Department to develop a separate agreement with this state. This agreement may cause slight variations from the guidance in this Bulletin for future BSA reporting requirements for the Department.

REPORTING EXPECTATIONS

Under the agreement entered into by NCUA and FinCEN, the Department is expected to identify and report significant BSA compliance violations to the NCUA, who will then report these violations to FinCEN. Significant BSA violations include pervasive violations, systemic violations, and repeat findings.

DEFINITIONS

A **pervasive** violation is "all-encompassing". A pervasive violation generally pertains to policies and procedures; it should be assessed from a strategic perspective. A partial list of examples follows:

- Absence of written policy and procedures
- Inadequate policy and procedures covering all essential elements
- Absence or lack of training for employees
- No independent review process
- Refusal to file a CTR or SAR for a single observable incident (could imply preferential treatment)
- Refusal to freeze an account when information appears to match a government listing

A **systemic** violation is a willful or reckless disregard for compliance with BSA provisions; it typically involves multiple incidents of noncompliance. A systemic violation should be assessed from a transactional perspective. A partial list of examples follows:

- Absence of a monetary transaction log
- Absence of CTR and/or SAR identification and filing process
- No records retention process
- No routine comparison with government lists
- Incomplete member or beneficiary information recorded in logs, CTSs and/or SARs
- No verification of member-furnished identifying information
- Not performing 314(a) searches in a timely manner
- Not reporting 314(a) matches in a timely manner
- More than one observable incident of not filing a CTR or SAR

Depending on the circumstances associated with an individual violation, a violation which, would usually be classified as systemic, may become pervasive.

A **repeat** violation is any violation (pervasive or systemic) that was previously identified and not resolved by a credit union.

CORRECTON OF VIOLATIONS

Once a significant BSA violation has been identified by examiners, it is important that credit union management correct the violation as soon as possible. The Department's examiners will set-up an acceptable time frame for the BSA violation to be corrected. Under NCUA plans, this time frame must be no longer than 90 days from the date the violation was discovered by the examiner. Individual credit unions will be required to forward documentation to the Department that shows the significant BSA violation was satisfactorily corrected. After the Department verifies that satisfactory correction was made, the Department will notify NCUA of the resolution. NCUA will in turn notify FinCEN that satisfactory correction was made. It is imperative that all significant BSA violations be corrected within 90 days of identification by the examiners.

EXAMINATION FOCUS

The Department encourages credit unions to be proactive in identifying weaknesses and problems in their credit union's BSA compliance program. Specifically, credit unions should take the following steps to ensure BSA compliance:

- Adopt strong BSA policies and procedures, which cover the required elements of BSA;
- Develop a system of internal controls to ensure ongoing BSA compliance;
- Assure that employees receive sufficient BSA compliance training;
- Test for BSA compliance, either by independent credit union staff or officials, or by an independent third party;
- Document that your credit union is properly meeting the BSA compliance requirements and retain those documents; and
- Stress the importance of BSA compliance to all staff members.

At a minimum, a satisfactory BSA policy should cover the following required elements:

- <u>Customer Identification Program (CIP)</u>

  - ❖ Identification of a member's name, date-of-birth, address, and identification number prior to account opening;
  - ❖ Verification of the information obtained.

- <u>Currency Transaction Report (CTR) Filings</u>

  - ❖ Are CTRs filed timely (within 15 days) when necessary (involves more than $10,000 in cash-in or cash-out)?
  - ❖ Does the credit union properly exempt permitted people from filing CTRs by filing a "Designation of Exempt Person" form?

- <u>Suspicious Activity Reports (SAR) Filings</u>

  - ❖ Are SARs filed within 30 days after discovery of a suspicious activity?
  - ❖ Is staff aware of what activity might be termed "suspicious"?

- <u>OFAC – Searching OFAC Lists for Prohibited Countries, Organizations and Individuals</u>

  - ❖ Does the credit union block or freeze accounts and transactions that are found to match the prohibited OFAC listing?
  - ❖ Does the credit union report this information to FinCEN immediately?

- Money Transfer Services

  - ❖ Credit unions that provide money transfer services (i.e. wire transfers) must obtain and record specific information on each money transfer of $3,000 or more.

- Maintain Necessary Information for the Purchase or Issuance, by Currency, Credit Union Checks, Cashier's Checks, Traveler's Checks, and Money Orders for Amounts Between $3,000 and $10,000

- Other BSA Compliance Requirements

CONCLUSIONS

The importance of following the BSA requirements cannot be over-emphasized. Federal government regulators, FinCEN, the Department of Homeland Security, OFAC and others, have elevated even more the importance of blocking transactions that occur at financial institutions that might benefit terrorism and drug trafficking. To this end, they have elevated the importance of BSA and are requiring that financial institutions, including credit unions and their regulators, elevate the importance of examining for BSA compliance. Federal monetary penalties can be assessed to financial institutions who do not comply with BSA; and both criminal charges and civil money penalties can be brought against individuals who are willfully non-compliant with BSA requirements.

Credit unions need to ensure that their policy and procedures are compliant with BSA, that employees are properly trained on BSA, and that internal controls are in place to ensure that employees are properly implementing these policies and procedures.

The requirements for BSA compliance do not vary based on the asset size of a credit union; however, the cost and type of action necessary to achieve compliance may vary. For example, a small, non-cash credit union, would need to have a BSA policy, but this credit union will have a very different policy (less complex and much smaller) than a large, multi-branch credit union.

Texas Credit Union Department

REGULATORY BULLETIN

February 27, 2006 RB 2006-01

Management Oversight by the Board of Directors

INTRODUCTION

As the credit union movement continues to evolve, the duties of directors are becoming more complicated and demanding. In addition, the recent corporate scandals and the Sarbanes-Oxley Act have raised public awareness in the area of corporate governance. Today's board of directors must take an active role in shaping and controlling a credit union's business operations and risks. The following briefly highlight the basic responsibilities the board has in actively overseeing the credit union's affairs:

- Establish goals, standards, policies and procedures, and operating strategies and understand the risks involved in following certain strategies.
- Establish a compliance program emphasizing the importance of regulatory compliance as an inherent part of credit union operations, ensuring compliance with external standards, such as laws and rules, and the credit union's own policies and procedures.
- Hire and retain the managing officer (president) with the skills, integrity, knowledge, and experience appropriate for the nature and scope of their responsibilities and periodically evaluate management's performance.
- Review audits, examinations, operating results, compliance performance and performance of new and existing activities.
- Ensure that the credit union serves the credit needs of its members.

Of these basic responsibilities, a board's most important responsibility is to select a capable president (manager) for the credit union.

HIRE AND RETAIN COMPETENT MANAGEMENT

Although economic conditions are a major influence on a credit union's well being, the most important factor in the success of a credit union is the quality of its management. It is rare that the cause of a serious problem or the failure of an institution is for reasons other than mismanagement. Most credit union failures are the result of inattentive, inadequate, or dishonest presidents. Therefore, a safe and sound credit union usually is the result of talented and capable management, which has the ability to manage day-to-day operations to achieve the credit union's performance goals. Such management has the industry expertise to help the board plan for the credit union's future in a changing and competitive marketplace, as well as generate new and innovative ideas for board consideration. It has the technical expertise to design and administer the systems and controls necessary to carry out the credit union's policies, to manage risks, and to ensure compliance with laws and rules.

When a credit union hires a president, the Board must actively manage the selection process. Selection criteria should include integrity, technical competence, character, and experience in the financial services industry. The board's choice for a president should share the board's operating philosophy and vision for the credit union to assure that mutual trust and a close working relationship are maintained.

COMPENSATION

Credit unions need to offer competitive compensation packages to hire and retain qualified management.

The Department recognizes that many credit unions feel they are at a disadvantage in competing for talent with other financial institutions who have more flexibility with compensation arrangements (e.g., granting stock options). The Department also recognizes that credit unions may use a combination of higher salaries, bonuses, and benefits to overcome this disadvantage.

The Department will ordinarily give healthy credit unions deference concerning compensation arrangements for their president provided the arrangements are reasonable and do not present significant safety and soundness concerns that could lead to material financial loss or damage to the credit union. For purposes of this bulletin, compensation includes any payment of money or provision of any other thing of value in consideration of employment, including, without limitation, base salary, bonuses, pension plans, severance payments, retirement, fringe benefits, payment of expense items without accountability or business purpose or that do not meet the IRS requirements for deductibility by an organization.

In determining the compensation of its president, the board of directors should consider at least the following factors:

- The qualification and experience of the president.
- The compensation paid to person having similar duties and responsibilities in other credit unions.
- The size of the credit union and the complexity of its operations.
- The financial condition, especially capital position and income level, of the credit union and the president's contribution to the credit union.
- Any other amounts the president receives, either directly or indirectly, for other services performed for the credit union.
- The value of personnel fringe benefits provided to the president, and perquisites such as an automobile, club membership, and expense account.

An increasing number of businesses today rely on incentive pay to motivate management to excel. The Department has no problem with incentive-base compensation but will object to any arrangements that provide incentives contrary to safe and sound operations of the credit union. For example, compensation based primarily on short-term operating results may encourage unreasonable risk-taking to achieve short-term profits. The board should closely monitor compensation tied to current operating results.

ENSURE QUALIFIED MANAGEMENT

The board should give the president the latitude he or she needs to run day-to-day operations; however, the board should implement a formal performance appraisal process to evaluate management's performance. Such a process helps to assure that periodic evaluations take place and demonstrates that the board is discharging it responsibility to supervise management. Performance appraisals should evaluate criteria relevant to the position, such as:

- The credit union's record of complying with laws and regulations.
- Criticisms contained in audit, examination reports, and member complaints and their resolution.
- Management's responsiveness to board directives, including compliance with board-approved policies.
- The timeliness, quality, and accuracy of management's recommendations and reports.
- Management's progress in implementing the credit union's strategic plan.
- Management's presentations to the board.
- The credit union's business success, including business performance indicators, such as actual versus projected performance, comparative credit union performance, and peer group comparison.

Although the board will only directly review the performance of the president, it should consider requiring performance appraisals by management for all other credit union employees. That will help it have strategies to retain competent management and staff, including compensation and benefit packages and succession. While the board should generally avoid reviewing and setting the specific compensation of employees other than the President, it should approve and periodically review the credit union's overall compensation package. Although compensation and benefit packages should be appealing, they should contain reasonable terms and conditions and not discriminate against any individuals or groups. They must not be excessive or lead to material financial loss for the credit union. While the board may want to consider the compensation and benefit packages of similarly situated credit unions, the board should tailor the compensation package to the credit union's size, its financial condition, and the nature, scope, and complexities of its operation.

The board should develop appropriate succession and transition strategies to address the loss of the president and other key positions. These strategies should identify critical positions and qualified potential replacements, including interim replacements. If no individual in the credit union is suitable, the succession strategy should identify a temporary replacement who could serve until the board finds a qualified successor. The board should review these contingency plans annually to determine if they remain workable.

If the board becomes dissatisfied with the performance of the president, it should address the matter directly. If the board needs to dismiss the president for poor performance, dishonesty, conflicts of interest, or for other reasons and it fails to do so, this failure may represent a serious breach of the board's responsibilities.

CONCLUSION

Change in the financial marketplace has created a more competitive and challenging environment for all credit unions. As a consequence of this change, the role of the credit union board members has grown in importance and complexity. The long-term health of a credit union depends on a strong, independent, and attentive board, which has placed the day-to-day operations of the credit union in the hands of qualified and competent management.

Texas Credit Union Department

REGULATORY BULLETIN

December 14, 2006 RB 2006-02

The Importance of Loan Policies

INTRODUCTION

Over the years, the fate of a credit union has been closely tied to how well it manages credit risk. A written loan policy, approved by a credit union's board of directors and adhered to in practice, is of critical importance in ensuring that the credit union operates in both a safe and a sound manner. In today's competitive and challenging lending environment, an up-to-date policy, appropriate to a credit union's lending function and business plan, may be more important than ever. This Bulletin summarizes features and benefits of an effective policy, details warning signs and potential consequences of an outdated policy, and offers practical advice about reviewing and updating a loan policy.

ELEMENTS OF AN EFFECTIVE LOAN POLICY

Written loan policies vary considerably in content, length, and specificity, as well as in style and quality. No two credit unions share the same tolerance for risk, offer the same loan products, and face the same economic conditions. An effective loan policy should reflect the size and complexity of a credit union and its lending operations and should be tailored to its particular needs and characteristics. Revisions should occur as circumstances change, and the policy should be flexible enough to accommodate new lending activity without a major renovation.

During examinations, examiners will make a determination about the adequacy of a credit union's loan policy. Examiners are guided in their review by rules, Department guidelines, and common sense: Is the policy up-to-date and are important areas adequately addressed? Commission Rule 91.701 details the areas that must be addressed in written loan policies. Regardless of a credit union's size or location, a loan policy should address:

- General areas of lending
- Lending authority of loan officers or committee
- Guidelines for the loan portfolio mix, risk diversification, appraisals, unsecured loans, and rates of interest
- Limitations on loan-to-value, and aggregate loans
- Credit and collateral documentation standards
- Collection procedures

- Internal controls to ensure compliance with the policy
- Methodology to be used to determine the amounts of an appropriate Allowance for Loan and Lease Losses

BENEFITS OF AN EFFECTIVE AND UP-TO-DATE LOAN POLICY

A sound loan policy, established and overseen by the board of directors, reflects favorably on the board and management. When a board sets forth its expectations clearly in writing, management is better positioned to control lending risks, ensure the credit union's stability and soundness, and fulfill oversight responsibilities. An effective and up-to-date loan policy increases the likelihood that actual loan documentation and underwriting practices will satisfy the board's expectations. Furthermore, a well-conceived policy clearly and comprehensively describes management's system of controls and helps examiners identify high-risk areas and prioritize and allocate examination time.

As part of the Department's risk-focused examination, examiners focus on areas that represent the greatest risk to the credit union. A written policy is tangible evidence of the processes that have been established to identify, measure, monitor, and control risks in the lending area. An incomplete or inadequate policy makes it more difficult to identify potential high-risk areas and may raise supervisory concerns about a credit union's risk management practices.

SIGNS THAT A LOAN POLICY NEEDS ATTENTION

A recent effective date on the cover of the policies does not provide adequate assurance that a policy is current. Only a careful review of the entire policy will reveal the extent of any shortcomings; however, even a cursory review can provide clues that a policy needs attention. Common red flags include:

- The policy has not been revised or re-approved in more than a year.
- Multiple versions of the policy are in circulation in the credit union.
- The table of contents is not accurate.
- The policy is disorganized.
- The policy contains misspellings, typos, and grammatical errors.
- Discontinued products are included, or new products are not addressed.
- New rules, which have been adopted by the Commission, are not addressed.

In addition, a review of actual lending decisions may identify areas where management is departing from the specifics of the loan policy, such as:

- Actual lending practices vary significantly from those outlined in the policy
- Numerous exceptions to policy requirements have been approved
- Policy limits are being ignored

Exceptions to policy should be few in number and properly justified, approved, and tracked. If actual practices vary materially from the written guidelines and procedures, the source of this discrepancy should be identified, and either actual practices or the written policy should be changed. Management may conclude that specific sections of the written policy are no longer relevant. A case is then made to the board of directors to amend the policy to reflect different, but still prudent, procedures and objectives.

POTENTIAL CONSEQUENCES OF AN INADEQUATE LOAN POLICY

Outdated and ineffective loan policies can contribute to a range of problems. Introducing a loan product that is not adequately addressed in the written loan policy can create a variety of challenges for the lending staff and involve risks that management did not anticipate.

If lending authorities, loan-to-value, and other lending limitations are not revised when circumstances change, a credit union could be operating within guidelines that are too restrictive, too lenient, or otherwise inappropriate in light of the credit union's current situation and lending environment. If guidelines do not comply with current laws and rules, lending decisions may not reflect best practices or regulatory requirements. Imprudent lending decisions can have a ripple effect. A loan policy that does not anticipate the risks inherent in a credit union's lending practices can lead to asset quality problems and poor earnings. In turn, earnings that do not fully support operations increase a credit union's vulnerability to adverse movements in interest rates, a downturn in the local economy, or other negative economic events.

THE LOAN POLICY UPDATING PROCESS

A credit union's loan policy is not a static document, but rather should be revised as the credit union, business conditions, rules, or regulations change. A comprehensive annual review, in addition to more limited reviews as needed, will help ensure that a loan policy does not become outdated and ineffective. The frequency and depth of the reviews will depend on circumstances specific to each credit union, such as growth expectations, competitive factors, economic conditions, staff expertise, and level of capital protection.

Planned changes to a credit union's lending function or business plan should prompt a modification to the policy. Pertinent criticisms and recommendations made during recent audits or examinations should be considered during the updating process.

The updating process also includes identifying obsolete or irrelevant sections of the policy. For example, a credit union might have entered a new field of lending a few years ago and modified its loan policy at that time. However, when it became obvious the credit union could not compete successfully in this field, management wound down the operations. The loan policy should reflect the decision to exit that lending niche.

Compliance testing, conducted as part of the updating and audit processes, will help management determine whether staff is aware of and adhering to the provisions of a loan policy. A credit union's board of directors should demonstrate their commitment by emphasizing that noncompliance is unacceptable. Loan staff, executive officers, and directors should be able to demonstrate some level of familiarity with all provisions—more so with the provisions that affect their daily responsibilities. Awareness and knowledge of the policy's specific provisions can be promoted through periodic training that stresses the need for the policy to keep pace with current lending activities and clarifies any areas of ambiguity or uncertainty. Specific areas that may benefit from review are:

- ranges for key numerical targets, such as loan-to-value ratios or loan portfolio segment allocations
- responsibilities for monitoring and enforcing loan policy requirements
- documentation requirements for various classes of loans
- remedial measures for loan policy infractions
- individual and committee lending authorities

CONCLUSION

A current and effective loan policy is a tool to help management ensure that a credit union's lending function is operating within established risk tolerances. Such a policy is more likely to be consulted and followed by staff and contributes to uniform and consistent board-approved practices. Therefore, credit union staff, members, and regulators will be well served by the implementation of a process that helps ensure that a credit union's loan policy is, and remains, comprehensive, effective, and up to date.

Texas Credit Union Department

REGULATORY BULLETIN

August 17, 2007 RB 2007-01

GUIDANCE ON THE NEW MORTGAGE FRAUD NOTICE

BACKGROUND

House Bill 716, passed by the 80th Legislature, amends Chapter 343 of the Finance Code and is intended to require all residential mortgage lenders to provide a new written notice at the time the mortgage loan is closed. The amendment prescribes the language and format of the notice, which warns borrowers of the penalties for making false or misleading statements to obtain a residential mortgage loan. The new law affects lenders making mortgage loans which are made to one or more individuals for personal, family, or household use. These loans are secured by a manufactured home or real property improved by a dwelling designed for occupancy by four or fewer families and are used, or to be used, as the borrower's principal residence. Although the Department believes the Legislature clearly intended to cover all such lenders, questions have recently been raised concerning the applicability of the requirement to state-chartered credit unions. This Guidance is being issued to strongly recommend compliance with the new §343.105, which is effective September 1, 2007.

GUIDANCE

Mortgage fraud is of increasing concern to the financial services industry and to the overall economy. In addition to requiring the notice, the bill enhances criminal penalties for mortgage fraud. Notifying borrowers before they close on a loan of the elements and penalties for mortgage fraud serves to both educate and warn the borrowers of the seriousness of the offense.

Given that the ultimate goal is to reduce mortgage fraud and the losses that result from it, and given the background and purpose of the legislation, credit unions are strongly urged to voluntarily comply with the notice requirements set out in HB 716. While the Department does not currently plan to write up credit unions for failing to provide the notice, the examiners will be asking for and documenting whether the notice required under §343.105 is being provided to credit union members.

POTENTIAL COMMISSION RULE

In view of the public policy considerations and the potential educational benefits for members, the Credit Union Commission will be considering the need and appropriateness of promulgating a rule that will clarify that residential mortgage loans written under the Credit Union Act must have this new notice. As with any proposed rule, if the Commission decides to impose such a requirement, notice of the proposed rulemaking will be published and comments from credit unions will be solicited.

NOTICE REQUIREMENTS OF §343.105 (HB 716)

The notice must:

(1) be provided on a separate document;
(2) be in at least 14-point type; and
(3) have the following or substantially similar language:

"Warning: Intentionally or knowingly making a materially false or misleading written statement to obtain property or credit, including a mortgage loan, is a violation of Section 32.32, Texas Penal Code, and, depending on the amount of the loan or value of the property, is punishable by imprisonment for a term of 2 years to 99 years and a fine not to exceed $10,000.

"I/we, the undersigned home loan applicant(s), represent that I/we have received, read, and understand this notice of penalties for making a materially false or misleading written statement to obtain a home loan.

"I/we represent that all statements and representations contained in my/our written home loan application, including statements or representations regarding my/our identity, employment, annual income, and intent to occupy the residential real property secured by the home loan, are true and correct as of the date of loan closing."

In addition, on receipt of the notice, the member shall verify the information and execute the notice.

CONCLUSION

The Department believes it is in the best interest of credit unions and their members for this notice to be given in a manner similar to that required of all other residential mortgage lenders in Texas. The Department, therefore, encourages all credit unions making residential mortgage loans to provide this notice to every applicant for a home loan.

Texas Credit Union Department

REGULATORY BULLETIN

September 30, 2008 RB 2008-01

ADVERTISING

It has come to our attention that some credit unions have engaged in very liberal advertising campaigns using such superlatives as "most secure," "strongest," and "safest" or that play on public fears about other types of financial institutions. We have received complaints about these ads since the claims convey information that typically is impossible to quantify or justify. While we recognize the competitive pressures in the financial services industry and the efforts of credit unions to differentiate products and services, we believe that this form of advertising is inappropriate and, in some cases, represents a violation of state and federal laws.

Recent news coverage has consumers worried about the safety of their deposits at financial institutions. At a time when it is incumbent upon all of us to minimize this public alarm and halt the decrease in public confidence, we instead are seeing ads by credit unions trying to capitalize on these fears. These ads undermine the public standing of other insured financial institutions and increase the public's concerns.

7 TAC Section 91.125 provides, among other things, that an advertisement shall be deemed to be misleading if it states that the credit union's services are superior to or of a higher quality than that of another financial institution unless the credit union can factually substantiate the statement. Advertising that implies that federally-insured funds may be more or less safe depending on where they are deposited is a clear misrepresentation of federal share and deposit insurance. Federal share and deposit insurance protection applies equally to all insured accounts regardless of the relative strength or financial performance of the institution.

Comparisons of the relative strengths of institutions is subjective and is frequently based on only a few criteria that fail to represent an institution's overall performance. Furthermore, claims of superiority evoke counterproductive rebuttal comparisons and serve to deteriorate the public's confidence in the federal share and deposit insurance system. While no one can ignore the tumultuous times that the financial services industry is experiencing, we believe that it is a mistake for financial institutions to work against one another publicly, particularly by playing on public fears. Given the current environment in which financial institutions are operating, it behooves credit unions to advocate the strengths of their products and services rather than denigrating others.

Whether we like it or not, we must face the fact that consumer confidence is the cornerstone of the financial system. Maintaining this confidence is the responsibility, and should be the utmost priority, of all credit unions as well as this Department.

Based on the many telephone calls we receive each week from consumers, it is clear that the public's main concern is "Are my funds insured?" The fundamental determinant of safety in the public's mind continues to be the insurance guarantee. Beyond that, few credit union members are in a position to evaluate and compare the relative merits of one financial report over another. Since any federally-insured account is exactly as safe as any other one, we strongly believe it is in the best interest of credit unions to emphasize insured safety, rather than exacerbating negative press coverage by suggesting that consumers should be anxiety-ridden and sleepless if their funds are on deposit elsewhere.

The erosion of public confidence is a high-risk problem for all of us. For credit unions making advertising claims that cannot be substantiated, corrective action will be required under 7 TAC Section 91.125. We request your cooperation in initiating any needed corrective measures in order to preserve the public's confidence in the federal share and deposit insurance system.

Texas Credit Union Department

REGULATORY BULLETIN

October 22, 2008 RB 2008-02

Allowance for Loan and Lease Losses

PURPOSE

This Bulletin updates the guidance on the Allowance for Loan and Lease Losses (ALLL) for state chartered credit unions originally issued by the Department in May 2000 (Regulatory Bulletin 2000-01). The information is primarily intended to reiterate key concepts and requirements included in Generally Accepted Accounting Principles (GAAP) and existing federal supervisory guidance. Detailed information on acceptable ALLL methodologies and related issues that apply to all federally-insured credit unions is available in the following supervisory statements issued by the National Credit Union Administration:

- NCUA Accounting Bulletin 09-01, *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)* – December 2006
- NCUA Letter to Credit Unions 02-CU-09 -- NCUA Interpretive Ruling and Policy Statement No. 02-3, *Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions* – June 2002

BACKGROUND

The ALLL is a valuation reserve established to recognize estimated loan impairment. The reserve is an accounting estimate of probable but unconfirmed asset impairment that has occurred in the loan portfolio as of the financial statement date. The determination of an appropriate ALLL level must be based on management's judgments about the credit quality of the loan portfolio and other relevant internal and external factors that affect loan collectability. A credit union that fails to maintain an adequate ALLL balance or related operating procedures will be considered to be operating in an unsafe and unsound manner.

REGULATORY STANDARD

Section 91.718(c) of the Rules of the Credit Union Commission details minimum regulatory standards for full and fair disclosure of the estimated loan losses. The rule specifies that the board of directors is responsible for ensuring controls are in place to consistently determine the ALLL in accordance with its written policies, GAAP, and relevant supervisory guidance. Each credit union is also required to develop, maintain, and document the methodology used to determine the appropriate ALLL and related loan loss expense. The rule further provides that adjustments to the ALLL must be made prior to the end of each calendar quarter to accurately reflect the loss exposure on the quarterly call report.

RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT

To ensure compliance with the regulatory standard, each credit union's board of directors must establish a written policy that addresses the procedures for evaluating the adequacy of the ALLL. The policy must be consistent with the size of the credit union and the nature and risk of its lending activities. Minimum policy requirements for all financial institutions are addressed in more detail in the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* issued jointly by the federal financial regulatory agencies in December 2006. At a minimum, each credit union's ALLL policy must ensure that:

- The process for determining an appropriate level for the ALLL is based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio.
- There is an effective loan review system and controls that identify, monitor, and address asset quality problems in an accurate and timely manner.
- There are adequate data capture and reporting systems to supply the information necessary to support and document its estimate of an appropriate ALLL.
- Loss estimation models are periodically evaluated to ensure that the resulting loss estimates are consistent with GAAP.
- Loans are promptly charged-off when available information confirms them to be uncollectible.
- The ALLL methodology is periodically reviewed and validated.

The board policy will serve as the basis for management to adjust the ALLL due to changes in the loss exposure from the loan portfolio. However, the credit union's board of directors remains responsible for overseeing management's assessment of the ALLL balance. At a minimum, the board's oversight must include:

- Reviewing and approving the institution's written ALLL policies and procedures at least annually.
- Reviewing management's assessment and justification that the loan review system is sound and appropriate for the size and complexity of the credit union
- Reviewing management's assessment and justification for the amounts estimated and reported each period for the ALLL and related loan loss expense.
- Requiring management to periodically validate and, when appropriate, revise the ALLL methodology.

METHODOLGY

The ALLL methodology is the system a credit union uses to reasonably estimate loan losses as of the financial statement date. Since no single method is deemed to be best, or appropriate for all credit unions, the Department does not require credit unions to use one specific methodology. However, each credit union must ensure that a comprehensive methodology is in place that satisfies the requirements of GAAP. The primary accounting standards for assessing loan loss exposure are detailed in Financial Accounting Standards No. 5 and 114 as discussed below.

Financial Accounting Standard No. 5, *Accounting for Contingencies* (FAS 5) is the most common method used to estimate the loss exposure in a credit union's loan portfolio. The guidance specifies that the loss on a loan be recognized when it is probable and can be reasonably estimated. Per FAS 5 guidelines, loans with like risk characteristics are pooled and a loss factor applied to the pool based on the historical loss rate for the loan type. The loss factor is normally based on the historical experience during the past 12-36 months. The loss factor(s) may be updated for recent changes in underwriting standards, staff experience, credit concentration, business conditions, and economic trends.

Small, less complex credit unions may elect to determine an appropriate level for the ALLL by simply segmenting the loan portfolio into secured consumer loans, unsecured consumer loans, and real estate loans. Larger, more complex institutions should have the ability to pool loans by grade (A, B, C or D paper) or other unique risk factors for each loan type.

Financial Accounting Standard No. 114 *Accounting for Contingencies for Impairment of a Loan* involves a review of individual loans that are impaired. This loss estimate method is generally used for larger or non-homogenous loans. The loss estimate for each loan must be based on the present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price. Individually reviewed loans that are determined not to be impaired under FAS 114 should be grouped with other loans that share similar risk characteristics and evaluated for impairment under FAS 5. Credit unions must avoid double counting the estimated loss on impaired loans by including them in both the FAS 114 and FAS 5 calculations.

EXAMINER RESPONSIBILITIES

Examiners will complete a review of the credit union's ALLL policy, methodology, and controls to determine compliance with supervisory guidance, GAAP, and Commission Rule 91.718. Specific steps that will be completed during the examination process include:

- Review the adequacy of the credit union's policy in relation to the size and complexity of the credit union.
- Determine whether the board of directors reviews and approves the policy and methodology at least annually.
- Determine whether the policy and procedures are consistent with GAAP and other supervisory guidance.
- Assess the adequacy of the supporting documentation for the ALLL methodology and calculations.
- Determine whether the ALLL provides a reasonable estimate of the loss exposure from the loan portfolio.

Texas Credit Union Department

REGULATORY BULLETIN

August 12, 2009 RB 2009-01

Risk Management: Asset Concentrations

The Department has growing concerns regarding asset concentrations and related risk management practices. Higher-risk asset concentrations have contributed significantly to an increase in the number of problems being identified during recent examinations. The Department is issuing this Bulletin to emphasize important risk management practices for credit unions' boards of directors and management and to encourage credit unions to revisit their existing concentration policies given the current economic environment.

Each credit union should implement a sound risk management framework to identify, measure, and control the level of concentration risk commensurate with the size and complexity of the institution. The framework should include: specific board and management oversight reports; standards for monitoring and managing the higher-risk concentrations; appropriate management information systems; strong credit underwriting standards; and a robust asset risk review function.

Concentration risk management and mitigation is essential regardless of economic conditions. The Department expects credit unions to develop risk management systems to ensure prudent underwriting and investment standards including board-approved reasonable limits for higher-risk concentrations. The board should review the risk management systems on a scheduled basis, including adjusting and refining concentration limits.

The Department examiners review a credit union's risk management practices in relation to concentrations that pose significant risks. For example, when there is significant exposure to purchased loans from third parties who control the servicing, disbursement, and collection processes, this relationship requires a more intensive review of the controls. The Department encourages the use of an independent, qualified third-party to review and monitor these relationships. The third-party review can be performed by an outside person or internal staff, but should retain its independence. An independent review is particularly important when the relationship involves higher-risk loans or investments and the institution lacks a strong risk management system.

The following list summarizes lessons learned from recent examinations. The Department examiners will consider these lessons while assessing a credit union's risk management systems.

- Market pressures and competition have compelled some credit unions to lower underwriting standards and loan terms to increase origination volume. Concentrations of loans originated under lowered standards increase risk.

- Higher-risk activities and concentration risks can be masked by financial success during periods of favorable economic conditions. Credit unions with concentration levels in higher risk activities should maintain sufficient net worth buffers in excess of Prompt Corrective Action "Well Capitalized" levels to compensate for the higher risk.

- Rapid growth in asset concentrations should be monitored carefully. Detection of underwriting deficiencies and loan performance weaknesses often occurs after the risk has grown to an excess level.

- Credit-related models are not likely to perform as well in a rapidly deteriorating environment. ALLL provisions methodologies are often based on historic loan performance resulting in reserve levels that do not keep pace with the current loan performance and losses. During economic fluctuations, management should shorten the "lookback" period for portfolio performance to ensure sufficient ALLLs.

The Department encourages credit unions to provide credit to qualified members for consumer and business purposes, provided that such credit is extended in a safe and sound manner. Credit unions must also document each borrower's willingness and ability to repay. Such documentation should be commensurate with the size and risk of the respective extensions of credit. Credit unions should ensure they adhere to prudent underwriting practices, particularly for loan portfolios with higher risk concentrations. Credit unions should not allow competitive pressures to erode the quality of underwriting.

Department examiners will closely review and scrutinize higher risk concentrations during examinations. These reviews will assess management and the Board's ability to establish appropriate concentration limits and implement effective risk management systems. The Department will exercise supervisory discretion in limiting or curtailing activities to prevent and limit unsafe and unsound business activities. The Department will pursue corrective action or enforcement action when a credit union does not maintain appropriate concentration limits or takes excessive risks.

Texas Credit Union Department

REGULATORY BULLETIN

November 12, 2009 RB 2009-02

Guidance on Other Real Estate Owned (OREO)

Introduction

Continued weakness in the housing market and the rise in foreclosure have increased the potential for credit unions to acquire other real estate. This bulletin is being issued to remind credit unions the need to establish policies and procedures for acquiring, holding, and disposing of OREO. These policies and procedures should ensure that the credit union's interests in the other real estate are protected while mitigating the impact on the value of surrounding properties; and follow safe and sound practices.

Background

Real estate acquired by foreclosure is generally an undesirable asset, and may be subject to additional losses, even when recorded at fair value. When the credit union's interest in OREO is compared with a performing loan, it becomes evident that OREO is a substandard investment. A loan generally is protected by the borrower's paying capacity and equity in the property. A performing loan earns interest, and all the expenses of holding the property are borne by the owner/borrower. Conversely, OREO is a non-earning asset with no cushion between the credit union's recorded investment and the fair value of the property. The credit union must expend time and resources to acquire, repair, and sell the property. Furthermore, the acquisition of the property indicates a lack of demand (at least at the current "asking price").

As used in this Bulletin, a credit union may hold OREO only if acquired by:

- Purchase under judicial or nonjudicial foreclosure, or through a deed in lieu of foreclosure, of real estate that is security for a debt or debts previously contracted in good faith;
- Purchase to protect its interest in a debt or debts previously contracted if prudent and necessary to avoid or minimize loss;
- Relocation of credit union premises; and
- Abandonment of plans to use real estate acquired for future expansion for credit union premises.

Initial Booking of OREO

7 TAC Section 91.515 requires OREO to be accounted for in accordance with generally accepted accounting principles (GAAP). Each parcel of OREO should be booked at the lower of its current book value (loan balance) or its fair value minus the estimated cost to sell the property on the date of transfer to the OREO category. The amount, if any, by which the recorded amount of the loan exceeds the fair value (less costs to sell) of the asset is a loss which must be charged to the allowance for loan and lease losses at the time of foreclosure.

Determining Fair Value

Upon transfer to OREO, fair value must be substantiated by a current appraisal prepared by an independent, qualified appraiser. All instructions from the credit union to the appraiser should be in writing. The appraiser should estimate the cash price that might be received upon exposure to the open market for a reasonable time, considering the property type and local market conditions. When a current sale is unlikely, i.e., when it is unlikely that the sale can be completed within 12 months, the appraiser must discount all cash flows generated by the property to obtain the estimate of fair value. Cash flows include, but are not limited to, those arising from ownership, development, operation, and sale of the property. The discount applied should reflect the appraiser's judgment of what a prudent/knowledgeable purchaser, under no necessity to buy, would be willing to pay for the property in a current sale. Whenever the appraiser believes that more than one year is necessary for a fair sale of the property, the appraiser should state and justify the estimated time and should state the annual discount rate applied. To substantiate the carrying value and to insure that the property has not declined in value, a new appraisal or a certification in letter form from an independent appraiser should be obtained annually.

Hold or Sell Decision

Once a credit union acquires an OREO property, the board should begin the decision-making process of whether to hold the property or sell it. A primary consideration when selling the asset is whether the credit union will have to make a loan to facilitate the sale. The credit union must consider the overall cost if it regains the property by later having to foreclose on the loan to facilitate. If a subsequent foreclosure becomes necessary, the condition of the property may be worse than when the credit union initially took possession. Moreover, if the most recent borrower fails to service the debt at all, the credit union has sacrificed any income it could have received from an interim use of the property.

In making the decision when and if to sell the OREO at the least cost to the credit union, the board should attempt to quantify, at a minimum, the following costs and benefits:

- Loss on an encumbered quick sale of property "as is."
- Cost of completing, restoring, and enhancing the project.
- Cost to prevent deterioration of the asset during the anticipated holding period:
    - Insurance
    - Physical security (fencing, security service, etc.)
    - Maintenance (mowing, utilities, structural repair, etc.)
    - Intangible (lost goodwill, etc.)
- Cost of selling the property (advertising, broker's commission, defects observed at inspection, etc.).
- Opportunity costs to the credit union, for example, based on the alternative uses of the sales proceeds.
- Cost of providing favorable financing.
- Anticipated appreciation or depreciation during the holding period.
- Benefit when the property is sold at the end of the holding period.

OREO Workouts

A credit union's board should assess the level of in-house expertise available to manage OREO workouts. A credit union should consider the possibility of looking outside the institution for the necessary level of expertise. This should include recruiting and employing real estate workout specialists and using real estate workout companies on a contract basis.

The board is responsible for reviewing the economic merits of out-sourcing OREO disposition plans. If any credit union identifies any regulatory issues of concern during its process of selecting an outside OREO workout program, it should raise these issues with the Department. Credit unions should be aware that the Department neither approves nor endorses specific OREO workout proposals.

Subsequent Costs

Ongoing expenses not associated with acquiring clear title to the property (i.e., taxes, hazard insurance, utilities, etc.) should be expensed as incurred. Costs incurred to protect the credit union's investment in OREO which is improved or under construction, and which are to place a property in a saleable condition may be capitalized in accordance with GAAP. Additional investments which alter the current status or intended use of the property or made for the purpose of speculating in real estate are not allowed.

Subsequent Valuations

If any subsequent valuation indicates a reduction in the value of a property below the current book value, the credit union should recognize the deficiency as a valuation allowance against the asset, which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) through charges or credit to expense for changes in the asset's value or estimated selling costs. In no event, however, should the carrying value of the property be increased to an amount greater than the original book value at the time of acquisition or transfer to the other real estate category. For reporting purposes, the reserve account should be netted against the book value of the OREO and is not considered as part of the credit union's net worth structure.

Maintenance of a general reserve for losses on the sale of OREO and write-downs below the appraised value are not consistent with GAAP. Write-downs below the appraised value should be supported by reasonable documentation.

Documentation Requirements

Credit unions are expected to maintain documentation showing compliance with GAAP and good faith efforts to dispose of each parcel of OREO. Minimum documentation includes:

- A current appraisal prepared by an independent, qualified appraiser;
- Specific action plans for disposal of each parcel of OREO. The review of such action plans should be recorded in the official records of the board;
- A record of inquiries and offers by potential buyers;
- Decisions made and actions taken by the board on all verbal or written offers received;
- Methods used in advertising the property for sale whether by the credit union or its agent; and
- Other information reflecting sales efforts

Holding Period

A credit union should dispose of OREO as soon as prudent business judgment dictates. Generally, however, the holding period should be no longer than two years from the date it is originally acquired or transferred to that asset category. If at any time before the end of the holding period the credit union can recover the amount of its original loan plus additional advances and other costs related to the loan or the parcel of OREO, it should promptly dispose of the parcel. If the OREO is not sold within the initial holding period, the credit union should contact the Department and provide justifying information, data and reports to substantiate the need to extend the holding period. A longer holding period may necessitate the funding of additional special reserves for the OREO property.

Credit Union Financing of OREO Purchases

If the sale of foreclosed property will be financed by the credit union at less than current market interest rates, GAAP requires that the loan be discounted to bring its yield to a market rate. The effect of the discount will be either to increase the loss or to reduce the gain that results from the sales transaction. Interest income is then recognized at a constant yield over the life of the loan.

In cases where the credit union facilitates the sale of foreclosed property by requiring little or no down payment, GAAP requires that the profit on sales of the foreclosed property be deferred until an adequate down payment (depending on the type of property, up to 25 percent of the discounted sales price) has been received. However, losses should be recorded immediately.

Conclusion

OREO is frequently an unsound asset, even when carried at or below the appraised value. The credit union's purchase of the property through foreclosure usually indicates a lack of demand. As time lapses, the lack of demand becomes more firm, and the soundness of real estate for which there is no demand becomes more questionable. Credit unions usually lose money in liquidating other real estate owned despite the apparent adequacy of the appraised value.

Examiners will review all relevant factors to determine the quality and risk of the parcel of OREO and the degree of probability that its carrying value will be realized. In conducting the analysis, some of the factors the examiner will consider include:

- The property's carrying value relative to its appraised value, the credit union's asking price, and offers received.
- The length of time the property has been on the market and local market conditions for the type of property involved, e.g., history of and trend of recent sales for comparable properties.
- The credit union's ability and track record in liquidating assets acquired in satisfaction of debts previously contracted.
- Income generated by the property and other economic factors affecting the probability of loss exposure.
- The manner in which the credit union intends to dispose of the property.
- The source and quality of the appraisal.
- Other pertinent factors, including the title, zoning, other liens, tax status, and insurance.

Texas Credit Union Department

REGULATORY BULLETIN

March 1, 2010 RB 2010-01

Restrictions Resulting from a Decline in Net Worth

Introduction

A credit union becomes subject to certain mandatory restrictions when its net worth ratio falls below 6%. Since these restrictions apply automatically, without action by the Department, this Bulletin is intended to provide guidance on determining the effective date of a change in net worth classification.

Definitions

Net worth means the retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles. It does not include the allowance for loan and lease losses account.

Net worth ratio means the ratio of the net worth of the credit union to the total assets of the credit union as reported on the most recent Call Report.

Specific Restrictions

A credit union with a net worth ratio that is less than 6% may not:

1. accept, renew, or roll over any brokered deposits;
2. make any member business loans;
3. purchase a participation in a member business loan;
4. pay any fees for directors or committee members attending meetings; or
5. invest in or make a loan to a credit union service organization (CUSO) that engages in activity other than the performance of services for credit unions or members of credit unions, where such activity equals or exceeds one half of the CUSO's total revenue.

General Guidelines

A credit union becomes subject to the specific restrictions as of the date it becomes aware of its net worth classification. A credit union shall be deemed to be aware of its net worth ratio no later than the last day of the calendar month following the end of the calendar quarter. Therefore, credit unions are responsible for monitoring their net worth ratio to remain alert to their net worth classification. Credit unions that operate with a net worth ratio at or near the 6% level must be attentive to the impact of the credit unions' operations on the net worth ratio to avoid violating any of the specific restrictions.

Failure to timely file a Call Report as required under Section 122.101 of the Texas Finance Code in no way alters the effective date of a change in net worth classification, or the credit union's corresponding legal obligation. Moreover, credit unions that incorrectly report their financial condition in their Call Report by deferring losses or by failing to make sufficient provisions for their loan and lease loss reserves violate the financial reporting provisions of Rule 91.515. Such violations may subject the credit union to enforcement actions.

Adjustment to Reported Net Worth Ratio

If a material event occurs between Call Report periods that would cause the net worth ratio to rise above 6%, the credit union may request the Department re-determine its net worth classification for purposes of these restrictions. Movement upward is not automatic and occurs only if agreed to in writing by the Department.

Texas Credit Union Department

REGULATORY BULLETIN

June 8, 2010 RB 2010-02

Accounting for Credit Losses

Introduction

Financial results clearly show the continued stress in credit union loan portfolios. The operating environment remains challenging with increased levels of unemployment, weakened residential real estate markets and mounting strains in the commercial real estate market. The combination of these factors has led to a growing level of nonperforming loans and foreclosures in the Texas credit union system. Additionally, there is a rising level of performing loans with underlying credit or documentation issues. Therefore, the Department is issuing this reminder regarding the importance of accurately accounting for credit losses.

Asset quality reviews continue to be a significant focus in examinations. Examiners continue to identify situations where credit unions have not provided for timely charge offs of nonperforming loans or established an adequate level of loan loss allowances relative to the credit union's risk exposures. Of particular concern is the increasing number of credit unions that do not have policies, procedures and written documentation related to impaired loans that are consistent with accounting standards.

Allowance for Loan and Lease Losses (ALLL)

The calculation of the ALLL represents one of the most significant estimates included in a credit union's financial statements. While generally accepted accounting principles regarding how to account for the provision and the ALLL have not changed in recent years, the current economic environment may require credit unions to reassess whether the information upon which the credit union bases its accounting decisions remains accurate. It is imperative that each credit union maintain an ALLL that is the result of a comprehensive and consistently applied process.

The ALLL should be maintained at a level appropriate to absorb estimated losses inherent in the loan portfolio, and should be well documented with clear explanations for supporting analysis, methodology and rationale. Credit unions should consider all significant factors, both positive and negative, that affect the collectability of loans. Credit unions that primarily use lagging data in their ALLL methodology for higher-risk loans should supplement and validate it with other methods that use more leading data when available. In addition, effective procedures to identify impaired loans and troubled debt restructuring are needed, as well as enhanced valuation analysis to ensure that the resulting loans are accounted for at appropriate valuations. The result should be an ALLL that is prudent and appropriate but not excessive.

Conclusions

Credit union management is responsible for maintaining appropriate accounting systems and documentation to support appropriate loan loss recognition. As we approach mid-year financials, the Department encourages credit union management to reassess its processes and systems for estimating credit losses and maintaining an appropriate ALLL.

In addition, Boards of Directors should ensure that future annual audits include appropriate review procedures to assess the effectiveness of the accounting for ALLL, appropriate loan loss recognition, and financial reporting and disclosures.

Texas Credit Union Department

REGULATORY BULLETIN

April 13, 2012 RB 2012-01

Guidance on Department's Examination Standards and Review of Examination Findings

Introduction

The Department is responsible for fostering the safety and soundness of the Texas credit union system and for monitoring and enforcing credit union compliance with applicable laws and regulations. In fulfilling these responsibilities, the Department strives to maintain open and ongoing communication with the credit unions it supervises. The Department is committed to a supervisory process that is fair and equitable.

Supervisory Objectives

The Department has established the following objectives for its supervisory program:

1. Ensure appropriate controls and management systems are in place to safeguard credit union assets, without attempting to completely eliminate risk.
2. Make sure credit unions act in accordance with applicable laws and regulations.
3. Encourage communication between the Department and credit unions to identify and resolve regulatory concerns.
4. Take fair and consistent administrative actions when necessary, based on facts and regulatory authority that have been clearly communicated to credit union management.
5. Provide credit unions with a review process through the Department's chain of command that credit unions can use without fear of retaliation.

Standards of Conduct

The Department's staff will:

1. Maintain objectivity and independence in the discharge of their professional responsibilities.
2. Maintain the highest standards of integrity in performing their duties.
3. Be available for open dialogue regarding examination findings and the application of applicable laws and regulations.

Examination Process

As part of the Department's examination process:

1. The examiner-in-charge will act as the central point of contact with the credit union.
2. Examiners will provide an independent evaluation of the condition of the credit union, as well as the levels and trends of the risks associated with current and planned activities.
3. Examiners will determine compliance with credit union laws and regulations.
4. Examiners will evaluate the effectiveness of any corrective actions undertaken to resolve regulatory concerns.
5. Examiners will provide an opportunity for the credit union to discuss the basis for the findings, provide additional data, or suggest alternative resolution for any regulatory concerns identified during the exam.
6. Examiners will meet with management prior to concluding the on-site examination to discuss findings, conclusions, and proposed corrective actions.

What Credit Unions Should Know

The credit union and the examiner-in-charge should thoroughly discuss any differences regarding examination findings. If the issues are not resolved at that level, the credit union should request additional involvement by the Field Manager or the Department's Chief Examiner. For differences that exist after the credit union has received the final report of examination, a credit union should submit a written response outlining the basis for its position. In addition, a credit union may request a review and a formal Department response regarding any examination finding. The Department is committed to making every effort to resolve examination disputes fairly, expeditiously, and amicably.

The Department expects its examination staff to interact with credit unions in a professional and fair manner. A credit union that experiences treatment that is not consistent with this standard or the standards addressed in this guidance should discuss their concerns with the Department's Field Manager, Chief Examiner, or Deputy Commissioner.

Formal Enforcement-Related Actions

Once a formal enforcement-related action or decision is issued under applicable statutes or regulations, a credit union may not seek review of examination findings via the informal process outlined above. At that point the action or decision becomes subject to the provisions of Title 7, Chapter 93 of the Texas Administrative Code, and a credit union may proceed with an appeal under that process.

Texas Credit Union Department

REGULATORY BULLETIN

June 18, 2012 RB 2012-02

Guidance on Commercial Mortgage-Related Securities

Introduction

Credit unions have long been authorized to invest in mortgage-related securities issued by federal government-sponsored enterprises. Recently a question arose whether this authority includes *commercial* mortgage-related securities issued by a federal government-sponsored enterprise. This Bulletin discusses the authority to invest in certain commercial mortgage-related securities and provides safety and soundness guidelines applicable to these securities.

Interpretation

Generally, 7 TAC Section 91.803 provides that credit unions may not purchase commercial mortgage-related securities. Section 124.351 of the Finance Code and 7 TAC Section 91.802, however, authorize credit unions to invest in securities issued by federal government-sponsored enterprises such as the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC).

Title 7 TAC Section 91.802(a)(10) incorporates United States Code Annotated, Title 15, Section 78c(a)(41)'s definition of mortgage-related security, which includes securities issued by an entity, *other than* a federal government-sponsored enterprise, backed by mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure. Reconciling the authorization of 7 TAC Section 81.802 with the prohibition in 7 TAC Section 91.803, a credit union is prohibited from purchasing commercial mortgage-related securities of an issuer *other* than a federal government-sponsored enterprise. Conversely, a credit union may purchase a commercial mortgage-related security issued by a federal government-sponsored enterprise.

Safety and Soundness Considerations

While this investment is permitted, it may not be suitable for every credit union. When selecting commercial mortgage-related securities consistent with safety and soundness, credit unions must carefully analyze the underlying commercial mortgages and corresponding collateral, as well as analyzing the cash flow, credit structure, and market performance of the security. As with all investments, credit unions must understand and be capable of managing the risks associated with commercial mortgage-related securities before purchasing them. 7 TAC Section 91.802 requires a credit union's board of directors to develop investment policies that address credit, liquidity, interest rate, and concentration risks. Policies must also identify investment characteristics that are suitable for the credit union. Credit unions that purchase commercial mortgage-related securities must develop sound risk management policies and construct limits that represent the board's risk tolerance.

Conclusions

Credit unions may invest in commercial mortgage-related securities issued by a federal government-sponsored enterprise but these investments require the same sound investment policies and practices as other investments. In brief, the board of credit unions purchasing commercial mortgage-related securities should:

1. diversify these investments by type, maturity, and degree of risk;
2. follow investment strategy that includes an asset-liability and rate sensitivity analysis;
3. deal with established, financially sound, and reputable broker/dealers;
4. determine that proper safekeeping of securities is maintained; and
5. monitor investments continually, review management performance, and determine compliance with policy.

Credit Union Department

REGULATORY BULLETIN

October 14, 2013 RB 2013-01

Guidance on Investing to Fund an Employee Benefit Plan Obligation

Introduction

The Department has received inquiries regarding a credit union's ability to purchase corporate or credit union owned life insurance policies insuring their employees' lives. Generally, these life insurance policies are purchased to help fund future financial obligations under a credit union's employee retirement or benefit plans.

The purpose of this Guidance is to outline the Department's position regarding a credit union's decision to purchase life insurance policies and to set forth guidelines addressing the due diligence considerations that should be undertaken by a credit union and its board of directors when deciding to purchase this insurance.

Availability of Federal Credit Union Power

NCUA regulations provide that:

> "A federal credit union investing to fund an employee benefit plan obligation is not subject to the investment limitations of the Act and Part 703 or, as applicable, Part 704, of this chapter and may purchase an investment that would otherwise be impermissible if the investment is directly related to the federal credit union's obligation or potential obligation under the employee benefit plan and the federal credit union holds the investment only for as long as it has an actual or potential obligation under the employee benefit plan." [12 C.F.R. Section 701.19(c)]

The NCUA adopted this regulatory provision in 2003. However, in doing so, NCUA declared that it was merely codifying its long-standing interpretation of the Federal Credit Union Act as set forth in previous NCUA general counsel opinion letters. Under this interpretation, federal credit unions have had the power to make otherwise impermissible investments to fund employee benefit obligations since before December 31, 1993.

Accordingly, a Texas-chartered credit union may exercise the same power pursuant to Section 123.003 of the Finance Code.

Credit Union Exercise of Federal Credit Union Power

Pursuant to NCUA regulation [12 C.F.R. Section 701.19], a federal credit union may invest in otherwise impermissible investments subject to three specific limitations:

1. The investment must be for the purpose of funding "an employee benefit plan" obligation. NCUA regulation provides that the term "employee benefit plan" has the same meaning as set forth in the Employment Retirement Income Security Act ("ERISA"), at 29 U.S.C. Section 1002(3). This ERISA provision states that "employee benefit plan" includes plans that are employee welfare benefit plans or employee pension benefit plans, or plans which are both. An employee pension benefit plan includes plans designed to provide retirement income to employees or resulting in deferral of employee income for periods extending through termination of covered employment and beyond. This ERISA provision also defines an "employee welfare benefit plan" as an employee benefit plan established for those providing medical, surgical, or hospital care, or benefits, or other benefits related to sickness, accident, disability, death, or unemployment, vacation benefits, apprenticeship or other training programs, daycare centers, scholarship funds, or prepaid legal services, or any other benefits described in ERISA, at 29 U.S. C. Section 186(c).
2. The investment must be "directly related to" the credit union's obligation or potential obligation. Under the NCUA regulation, a credit union must be able to demonstrate that the otherwise impermissible investments are "directly related" to the credit union's benefit obligations. The credit union may not invest more than is necessary to fund the benefits in question. This calculation is performed by determining (as closely as possible) the amount of the credit union's anticipated benefit obligation and determining the amount that must be invested based on the anticipated rate of return in order to fund that obligation. This amount will allow the credit union to recoup its initial investment as well as the amount necessary to fund the employee benefit obligation. In addition, the credit union may also invest enough to recover its costs associated with the benefit and the cost of funding.
3. The credit union may hold the investment only for the period during which it has an actual or potential obligation under the plan in question. The credit union may only hold such impressible investments for as long as the credit union has an employee benefit obligation that the investments are intended to fund. Thus, for example, if the credit union holds an investment for the purpose of funding retirement benefits for a particular employee and the employee retires and the obligation is paid, the credit union must divest of the investment unless it has incurred additional employee benefit obligations that would replace the original one and would be directly related to the investment in question.

Purchase and Holding of Insurance Products

A credit union may exercise federal credit union powers to purchase and hold life insurance products to fund employee benefit plans so long as the credit union conforms to all standards set forth in this Guidance, including without limitation, the Interagency Statement issued by the Federal Banking Agencies on December 7, 2004, which is attached to and made part of this Guidance. In addition, the Department recommends a credit union set a concentration limit on life insurance to an overall aggregate cash surrender value ("CSV") not to exceed twenty-five percent (25%) of its net worth and further set a concentration limit on an aggregate CSV of life insurance from any one life insurance company not to exceed fifteen (15%) of net worth.

Due Diligence and Safety and Soundness Considerations

Because of the complexity of many of the life insurance policies, and the fact that life insurance is a form of long term financial commitment with various components of risk, credit unions and their boards of directors should take appropriate steps to assure they are making informed decisions about purchasing life insurance, consistent with safety and soundness principles. Risks to be analyzed which are associated with these types of insurance products include transaction, credit, interest rate, liquidity, compliance, and price risks. These risks are discussed in detail in the attached Interagency Statement.

The Department believes the due diligence and safety and soundness considerations have been adequately and appropriately addressed by the Interagency Statement. It is the position of the Department that credit unions considering any life insurance purchase should also address and satisfy each of the due diligence considerations set forth in the Interagency Statement. The Department notes that the Interagency Statement requires institutions not only to make and document an appropriate pre-purchase review and analysis, but also to conduct appropriate post-purchase reviews of the insurance product.

Conclusion

Based on the foregoing, a credit union may make investments that are not otherwise permitted to Texas-chartered credit unions for the expressed purpose of funding employee benefit obligations. In making such investments, a credit union is subject to all of the limitations set forth in the NCUA regulations and other NCUA authority interpreting and applying these regulations, as well as this Guidance.

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

INTERAGENCY STATEMENT ON THE PURCHASE AND RISK MANAGEMENT OF LIFE INSURANCE

PURPOSE

This interagency statement provides general guidance for banks and savings associations (institutions) regarding supervisory expectations for the purchase of and risk management for bank-owned life insurance (BOLI). It also provides guidance for split-dollar arrangements and the use of life insurance as security for loans. The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (agencies) are providing this guidance for institutions to help ensure that their risk management processes for BOLI are consistent with safe and sound banking practices. Among the safe and sound banking practices discussed in this interagency statement is the need for senior management and board oversight of BOLI, including both a thorough pre-purchase analysis of risks and rewards and post-purchase risk assessment. The guidance discusses the permissibility of BOLI purchases and holdings, as well as their risks and associated safety and soundness considerations. The appendix to this document contains a discussion of insurance types and the purposes for which institutions commonly purchase life insurance, as well as a glossary of BOLI-related terminology.

The guidance in this interagency statement for the pre-purchase analysis of life insurance applies to all BOLI contracts entered into after the date of this interagency statement. The guidance concerning the ongoing risk management of BOLI subsequent to its purchase applies to all holdings of life insurance regardless of when purchased. Institutions that purchase life insurance after the date of this interagency statement that are not in compliance with this guidance may be subject to supervisory action. Institutions that entered into BOLI contracts before this date will be evaluated according to each agency's pre-purchase guidance in effect at that time.

Compliance with the supervisory guidance in this interagency statement regarding permissible uses for insurance (*e.g.*, recovery of the costs of providing benefits) does not determine whether the policy satisfies state insurable interest requirements.

BACKGROUND

Life insurance holdings can serve a number of appropriate business purposes. Because the cash flows from a BOLI policy are generally income tax-free if the institution holds the policy for its full term, BOLI can provide attractive tax-equivalent yields to help offset the rapidly rising cost of providing employee benefits. Over the past several years, however, a growing number of institutions have aggressively increased their holdings of BOLI. A number of institutions own life insurance with an aggregate cash surrender value (CSV) in excess of 25 percent of capital even though the agencies have previously identified this capital concentration threshold as the level that institutions should consider when establishing internal limits for their BOLI holdings.

Some institutions have acquired BOLI as part of a "yield-chasing" asset/liability management strategy in an attempt to increase earnings during the recent period of low interest rates and reduced loan demand. The agencies are concerned that some institutions have committed a significant amount of capital to BOLI without having an adequate understanding of the full array of risks it poses – especially risks that are difficult to measure, such as liquidity, transaction/operational, reputation, and compliance/legal risks. The agencies expect institutions to implement appropriate risk management processes including meaningful risk limits before implementing or adding to a BOLI program.

The guidance is organized as follows:

- Legal Authority
- Accounting Considerations
- Supervisory Guidance
- Risk Management of BOLI
- Risk-Based Capital Treatment
- Summary
- Appendix

LEGAL AUTHORITY

National banks may purchase and hold certain types of life insurance under 12 USC 24 (Seventh), which provides that national banks may exercise "all such incidental powers as shall be necessary to carry on the business of banking." Federal savings associations also may purchase and hold certain types of life insurance incidental to the express powers granted under the Home Owners' Loan Act. The OCC and OTS have delineated the scope of these authorities through various interpretations addressing the permissible use of life insurance by national banks and federal savings associations.

Under these authorities, national banks and federal savings associations may purchase life insurance in connection with employee compensation and benefit plans, key person insurance, insurance to recover the cost of providing pre- and post-retirement employee benefits, insurance on borrowers, and insurance taken as security for loans. The OCC and OTS may approve other uses on a case-by-case basis.

National banks and federal savings associations may *not* purchase life insurance:

- For speculation;
- To provide funds to acquire shares of stock from the estate of a major shareholder upon the shareholder's death, for the further purpose of controlling the distribution of ownership in the institution;
- As a means of providing estate-planning benefits for insiders, unless the benefit is a part of a reasonable compensation package; or
- To generate funds for normal operating expenses other than employee compensation and benefits.

These restrictions apply even if a national bank or a federal savings association is a Subchapter S corporation for federal income tax purposes.

National banks and federal savings associations may not hold life insurance in excess of their risk of loss or cost to be recovered. For example, once an individual no longer qualifies as a key person because of retirement, resignation, discharge, change of responsibilities, or for any other reason, the risk of loss has been eliminated. Therefore, national banks and federal savings associations may be required to surrender or otherwise dispose of key person life insurance held on an individual who is no longer a key person. Typically, term or declining term insurance is the most appropriate form of life insurance for key person protection.

National banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity securities held in a separate account[1] of the insurance company) only for the purpose of economically hedging their equity-linked obligations under employee benefit plans. As discussed more fully in the section on "Price Risk," for equity-linked variable life insurance holdings to be permissible, the national bank or federal savings association must demonstrate that:

- It has a specific, equity-linked obligation; and
- Both at the inception of the hedge and, on an ongoing basis, changes in the value of the equity-linked variable life insurance policy are highly correlated with changes in the value of the equity-linked obligation.

If a national bank or federal savings association does not meet these requirements, the equity-linked variable life insurance holdings are not permissible. The use of equity-linked variable life insurance holdings as a long-term hedge against general benefit costs is not permissible because the life insurance is not hedging a specific equity-linked liability and does not meet the "highly correlated" requirement.

As a general matter, the ability of state-chartered banks to purchase insurance (including equity-linked variable life insurance) is governed by state law. In some instances, state laws permit state-chartered banks to engage in activities (including making investments) that go beyond the authority of a national bank. The Federal Deposit Insurance Act (section 24) generally requires insured state-chartered banks to obtain the FDIC's consent before engaging as principal in activities (including making investments) that are not permissible for a national bank. Similarly, the Federal Deposit Insurance Act (section 28) generally requires a state-chartered savings association to obtain the FDIC's consent prior to engaging as principal in activities (including making investments) that are not permissible for a federal savings association. While insured state-chartered banks and state savings associations may seek the FDIC's consent to make purchases of life insurance that would not be within the authority of a national bank or federal savings association, such banks and savings associations should be aware that the FDIC will not grant permission to make life insurance purchases if the FDIC determines that doing so would present a significant risk to the deposit insurance fund or that engaging in such purchases is inconsistent with the purposes of federal deposit insurance.

[1] A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's cash surrender value is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder neither owns the underlying separate account nor controls investment decisions (*e.g.*, timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

ACCOUNTING CONSIDERATIONS

Institutions should follow generally accepted accounting principles (GAAP) applicable to life insurance for financial and regulatory reporting purposes. Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance* (TB 85-4), discusses how to account for holdings of life insurance. Under TB 85-4, only the amount that could be realized under an insurance contract as of the balance sheet date (that is, the CSV reported to the institution by the carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset. The guidance set forth in TB 85-4 concerning the carrying value of insurance on the balance sheet is generally appropriate for all forms of BOLI.

An institution may purchase multiple permanent insurance policies from the same insurance carrier with each policy having its own surrender charges. In some cases, the insurance carrier will issue a rider or other contractual provision stating that it will waive the surrender charges if all of the policies are surrendered at the same time. Because it is not known at any balance sheet date whether one or more of the policies will be surrendered before the deaths of the insureds, the possibility that the institution will surrender all of these policies simultaneously and avoid the surrender charges is a gain contingency. Under FASB Statement No. 5, *Accounting for Contingencies*, "[c]ontingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." Accordingly, an institution should report each of the insurance policies on its balance sheet at the policy's CSV reported by the insurance carrier, less any applicable surrender charges not reflected in the reported CSV, without regard to the existence of the rider.

In accordance with the instructions for Consolidated Reports of Condition and Income and Thrift Financial Reports, an institution should report the carrying value of its BOLI holdings as an "other asset" and the earnings on these holdings should be reported as "other noninterest income."

The agencies have seen a number of cases in which institutions have failed to account properly for a type of deferred compensation agreement, commonly referred to as a revenue-neutral plan or an indexed retirement plan. The accounting for such plans is separate and distinct from the accounting for BOLI. However, because many institutions buy BOLI to help offset the cost of providing such deferred compensation, the agencies have issued guidance addressing the accounting requirements for both deferred compensation agreements and BOLI. See the "Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance," dated February 11, 2004, for a complete description, including examples, of the appropriate accounting treatment.

SUPERVISORY GUIDANCE

Before entering into a BOLI contract, institutions should have a comprehensive risk management process for purchasing and holding BOLI. A prudent risk management process includes:

- Effective senior management and board oversight;
- Comprehensive policies and procedures, including appropriate limits;
- A thorough pre-purchase analysis of BOLI products; and
- An effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks.

The risks associated with temporary (term) insurance are significantly less than those arising from holdings of permanent insurance. Accordingly, the risk management process for temporary insurance may take this difference into account and need not be as extensive as the risk management process for permanent insurance.

Senior Management and Board Oversight

The safe and sound use of BOLI depends on effective senior management and board oversight. Regardless of an institution's financial capacity and risk profile, the board must understand the complex risk characteristics of the institution's insurance holdings and the role this asset is intended to play in the institution's overall business strategy. Although the board may delegate decision-making authority related to purchases of BOLI to senior management, the board remains ultimately responsible for ensuring that the purchase and holding of BOLI is consistent with safe and sound banking practices.

An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety and soundness concern, the appropriate agency may take supervisory action against the institution, including requiring the institution to divest affected policies, irrespective of potential tax consequences.

Policies and Procedures

Consistent with prudent risk management practices, each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate CSV of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. When establishing these internal CSV limits, an institution should consider its legal lending limit, the capital concentration threshold, and any applicable state restrictions on BOLI holdings.[2] In this regard, given the liquidity, transaction/operational, reputation, and compliance/legal risks associated with BOLI, it is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines.[3] Therefore, the agencies expect an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of 25 percent of capital, or any lower internal limit, to gain prior approval from its board of directors or the appropriate board committee. The agencies particularly expect management to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of capital does not constitute an imprudent capital concentration. An institution holding BOLI in an amount that approaches or exceeds the 25 percent of capital concentration threshold can expect examiners to more closely scrutinize the

[2] In July 1999, the OTS adopted a policy that savings associations may not invest more than 25 percent of their total capital in BOLI without first notifying and obtaining authorization from their OTS Regional Office. In order to maintain strong and effective communications with institutions under its supervision, the OTS retains this policy. The other agencies may also institute approval or notification requirements.

[3] Each agency's definition of a concentration differs slightly. Institutions should refer to the definition provided by their supervisory agency when measuring the CSV of BOLI as a percentage of capital: OCC Bulletin 95-7 for national banks; FRB Commercial Bank Examination Manual Section 2050.1 for state member banks; FDIC Manual of Examination Policies, Section 11.1 for insured state nonmember banks; and OTS Thrift Activities Handbook, Section 211 for savings associations.

risk management policies and controls associated with the BOLI assets and, where deficient, to require corrective action.

When seeking the board's approval to purchase or increase BOLI, management should inform the board members of the existence of this interagency statement, remind them of the illiquid nature of the insurance asset, advise them of the potential adverse financial impact of early surrender, and identify any other significant risks associated with BOLI. Such risks might include, but are not limited to, the costs associated with changing carriers in the event of a decline in the carrier's creditworthiness and the potential for noncompliance with state insurable interest requirements and federal tax law.

Pre-purchase Analysis

The objective of the pre-purchase analysis is to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should also take into account existing BOLI holdings. A mark of a well-managed institution is the maintenance of adequate records concerning its pre-purchase analyses, usually including documentation of the purpose and amount of insurance needed.

An effective pre-purchase analysis involves the following management actions:

I. Identify the Need for Insurance and Determine the Economic Benefits and Appropriate Insurance Type

An institution should determine the need for insurance by identifying the specific risk of loss to which it is exposed or the specific costs to be recovered. It is not appropriate to purchase life insurance to recover a loss that the institution has already incurred. An institution's purchase of insurance to indemnify it against a specific risk of loss does not relieve it from other responsibilities related to managing that risk. The type of BOLI product, *e.g.*, general[4] or separate account, and its features should be appropriate to meet the identified needs of the institution. The appendix contains a description of insurance types and design features.

An institution should analyze the cost and benefits of planned BOLI purchases. The analysis should include the anticipated performance of the BOLI policy and an assessment of how the purchase will accomplish the institution's objectives. Before purchasing BOLI, an institution should analyze projected policy values (CSV and death benefits) using multiple illustrations of these projections provided by the carrier, some of which incorporate the institution's own assumptions. An institution should consider using a range of interest-crediting rates and mortality-cost assumptions. In some cases, the net yield (after mortality costs) could be negative, particularly for separate account products. The potential for unfavorable net yields underscores the importance of carefully evaluating BOLI costs and benefits across multiple scenarios, both currently and into the future.

[4] A general account is a design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policyholder's CSV.

II. Quantify the Amount of Insurance Appropriate for the Institution's Objectives

An institution should estimate the size of the employee benefit obligation or the risk of loss to be covered and ensure that the amount of BOLI purchased is not excessive in relation to this estimate and the associated product risks. When using BOLI to recover the cost of providing employee benefits, the estimated present value of the expected future cash flows from BOLI, less the costs of insurance, should not exceed the estimated present value of the expected after-tax employee benefit costs. In situations where an institution purchases BOLI on a group of eligible employees, it may estimate the size of the obligation or the risk of loss for the group on an aggregate basis and compare that to the aggregate amount of insurance to be purchased. This estimate should be based on reasonable financial and actuarial assumptions. State insurable interest laws may further restrict or limit the amount of insurance that may be purchased on a group of employees. Management must be able to support, with objective evidence, the reasonableness of all of the assumptions used in determining the appropriate amount of insurance coverage needed by the institution, including the rationale for its discount rates and cost projections.

III. Assess Vendor Qualifications

When making a decision about vendors, an institution should consider its own knowledge of insurance risks, the vendor's qualifications, and the amount of resources the institution is willing to spend to administer and service the BOLI. Depending on the role of the vendor, the vendor's services can be extensive and may be critical to successful implementation and operation of a BOLI plan, particularly for the more complex separate account products.

While it is possible to purchase insurance directly from insurance carriers, the vast majority of insurance purchases are made through vendors – either brokers, consultants, or agents. A vendor may design, negotiate, and administer the BOLI policy. An institution should ensure that it understands the product it is purchasing and that it selects a product that best meets its needs. Management, not just the vendor, must demonstrate a familiarity with the technical details of the institution's insurance assets, and be able to explain the reasons for and the risks associated with the product design features they have selected.

An institution that uses a vendor should make appropriate inquiries to satisfy itself about the vendor's ability to honor its long-term commitments, particularly when the vendor is expected to be associated with the institution's insurance program over an extended period of time. The institution should evaluate the adequacy of the vendor's services and its reputation, experience, financial soundness, and commitment to the BOLI product. Vendors typically earn a large portion of their commissions upon the sale of the product, yet they often retain long-term servicing responsibilities for their clients. The vendor's commitment to investing in the operational infrastructure necessary to support BOLI is a key consideration in vendor selection.

An institution should be aware that the vendor's financial benefit from the sale of insurance may provide the vendor with an incentive to emphasize the benefits of a BOLI purchase to the institution without a commensurate explanation of the associated risks. Therefore, reliance solely upon pre-packaged, vendor-supplied compliance information does *not* demonstrate prudence with respect to the purchase of insurance. An institution should not delegate its selection of product design features to its vendors. An institution that is unable to demonstrate a thorough understanding of BOLI products it has purchased and the associated risks may be subject to supervisory action.

IV. Review the Characteristics of the Available Insurance Products

There are a few basic types of life insurance products in the marketplace. These products, however, can be combined and modified in many different ways. The resulting final product can be quite complex. Furthermore, certain permanent insurance products have been designed specifically for banks. These products differ from other forms of corporate-owned life insurance (COLI) policies in that the policies designed for banks are generally structured without surrender or front-end sales charges in order to avoid having to report these charges as expenses when initially recording the carrying value. However, BOLI products may have lower net yields than COLI products due to the absence of these charges. An institution should review the characteristics of the various insurance products available, understand the products it is considering purchasing, and select those with the characteristics that best match the institution's objectives, needs, and risk tolerance.

Design features of permanent insurance policies determine: 1) whether the policy is a general account, separate account, or hybrid product;[5] 2) whether the insurance contract is a modified endowment contract (MEC) that carries certain tax penalties if surrendered; and 3) the method used to credit earnings to the policy. Some implications of these design features are discussed in more detail in the "Risk Management of BOLI" section of this interagency statement.

When purchasing insurance on a key person or a borrower, management should consider whether the institution's need for the insurance might end before the insured person dies. An institution generally may not hold BOLI on a key person or a borrower once the key person leaves the institution or the borrower has either repaid the loan, or the loan has been charged off. Therefore, the maturity of the term or declining term insurance should be structured to match the expected tenure of the key person or the maturity of the loan, respectively. Permanent insurance generally is not an appropriate form of life insurance under these circumstances.

V. Select Carrier

To achieve the tax benefits of insurance, institutions must hold BOLI policies until the death of the insured. Therefore, carrier selection is one of the most critical decisions in a BOLI purchase and one that can have long-term consequences. While a broker or consultant may assist the institution in evaluating carrier options, the institution alone retains the responsibility for carrier selection. Before purchasing life insurance, an institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending. A more complete discussion of the credit analysis standards is included in the "Credit Risk" section of this interagency statement.

Management should review the product design, pricing, and administrative services of proposed carriers and compare them with the institution's needs. Management should also review the carrier's commitment to the BOLI product, as well as its credit ratings, general reputation, experience in the marketplace, and past performance. Carriers not committed to general account BOLI products may have an incentive to lower the interest-crediting rate on BOLI over time, reducing the favorable economics of the product. The interest-crediting rate refers to the gross yield on the investment in the insurance policy, that is, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are

[5] A hybrid product combines features of both general and separate account products.

periodically charged against the policy's cash value. Insurance companies frequently disclose both a current interest-crediting rate and a guaranteed minimum interest-crediting rate. Institutions should be aware that the guaranteed minimum interest-crediting rate may be periodically reset in accordance with the terms of the insurance contract. As a result, the potential exists for a decline in the interest-crediting rate.

While institutions can exercise what is known as a 1035 Exchange[6] option to change carriers, there are some practical constraints to using this option. First, the institution must have an insurable interest in each individual to be insured under the new carrier's policy. In a 1035 Exchange, former employees of the institution may not be eligible for coverage under the new policy because state insurable interest laws may prohibit their eligibility. Second, the original carrier may impose an exchange fee specifically applicable to such 1035 Exchanges.

VI. Determine the Reasonableness of Compensation Provided to the Insured Employee if the Insurance Results in Additional Compensation

Insurance arrangements that are funded by the institution and that permit the insured officer, director, or employee to designate a beneficiary are a common way to provide additional compensation or other benefits to the insured. Split-dollar life insurance arrangements are often used for this purpose. Before an institution enters into a split-dollar arrangement or otherwise purchases insurance for the benefit of an officer, director, or employee, the institution should identify and quantify its compensation objective and ensure that the arrangement is consistent with that objective. The compensation provided by the split-dollar or other insurance arrangement should be combined with all other compensation provided to the insured to ensure that the insured's total compensation is not excessive. Excessive compensation is considered an unsafe and unsound banking practice. Guidelines for determining excessive compensation can be found in the Interagency Guidelines Establishing Standards for Safety and Soundness.[7]

Because shareholders and their family members who are not officers, directors, or employees of an institution do not provide goods or services to the institution, they should not receive compensation from the institution. This includes compensation in the form of split-dollar life insurance arrangements.

Prior to an institution's purchase of a life insurance policy to be used in a split-dollar life insurance arrangement, the institution and the insured should enter into a written agreement. Written agreements usually describe the rights of the institution, the insured individual, and any other parties (such as trusts or beneficiaries) to the policy's CSV and death benefits. It is important for an institution to be aware that ownership of the policy by the employee, a third party, or a trust (non-institution owner) may not adequately protect the institution's interest in the policy because the institution ordinarily will not have the sole right to borrow against the CSV or to liquidate the policy in the event that funds are needed to provide liquidity to the institution. Moreover, if a non-institution owner borrows heavily against the CSV, an institution's ability to recover its premium payments upon the death of the insured may be impaired.

[6] A 1035 Exchange is a tax-free replacement of an insurance policy for another insurance contract covering the same person in accordance with section 1035 of the Internal Revenue Code.
[7] For national banks, Appendix A to 12 CFR 30; for state member banks, Appendix D-1 to 12 CFR 208; for insured state nonmember banks, Appendix A to 12 CFR 364; for savings associations, Appendix A to 12 CFR 570.

At a minimum, an institution's economic interest in the policy should be equal to the premiums paid plus a reasonable rate of return, defined as a rate of return that is comparable to returns on investments of similar maturity and credit risk.

Split-dollar life insurance has complex tax and legal consequences. An institution considering entering into a split-dollar life insurance arrangement should consult qualified tax, legal, and insurance advisors.

VII. Analyze the Associated Risks and the Ability to Monitor and Respond to those Risks

An institution's pre-purchase analysis should include a thorough evaluation of all significant risks, as well as management's ability to identify, measure, monitor, and control those risks. An explanation of key risks (liquidity, transaction/operational, reputation, credit, interest rate, compliance/legal, and price) is included in the "Risk Management of BOLI" section of this interagency statement.

VIII. Evaluate Alternatives

Regardless of the purpose of BOLI, a comprehensive pre-purchase analysis will include an analysis of available alternatives. Prior to acquiring BOLI, an institution should thoroughly analyze the risks and benefits, compared to alternative methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation, as appropriate.

IX. Document Decision

A well-managed institution maintains adequate documentation supporting its comprehensive pre-purchase analysis, including an analysis of both the types and design of products purchased and the overall level of BOLI holdings.

RISK MANAGEMENT OF BOLI

Risk assessment and risk management are vital components of an effective BOLI program. In addition to conducting a risk assessment as part of a thorough pre-purchase analysis, monitoring BOLI risks on an ongoing basis is important, especially for an institution whose aggregate BOLI holdings represent a capital concentration. Management of an institution should review the performance of the institution's insurance assets with its board of directors at least annually. More frequent reviews are appropriate if there are significant anticipated changes to the BOLI program such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the performance of BOLI. This risk management review should include, but not necessarily be limited to:

- *Comprehensive assessment of the specific risks discussed in this section.*[8]

[8] All of the risks discussed in this section are applicable to permanent insurance. In contrast, because temporary insurance does not have a savings component or a CSV, it does not expose an institution to liquidity, interest rate, or price risk. These risks need not be evaluated in the comprehensive assessment of the risks of temporary insurance.

- *Identification of which employees are, or will be, insured (e.g., vice presidents and above, employees of a certain grade level).* For example, an institution that acquires another institution that owns BOLI may acquire insurance on individuals that it would not insure under its own standards. While the acquiring institution need not correct such exceptions, it is important to know that such exceptions exist.
- *Assessment of death benefit amounts relative to employee salaries.* Such information helps management to assess the reputation and insurable interest risks associated with disproportionately large death benefits.
- *Calculation of the percentage of insured persons still employed by the institution.* Larger institutions often find that their policies insure more former employees than current employees. This information can help the institution assess reputation risk.
- *Evaluation of the material changes to BOLI risk management policies.*
- *Assessment of the effects of policy exchanges.* Exchanges typically are costly and it is a sound practice to review the costs and benefits of such actions.
- *Analysis of mortality performance and impact on income.* Material gains from death benefits can create reputation risks.
- *Evaluation of material findings from internal and external audits and independent risk management reviews.*
- *Identification of the reason for, and tax implications of, any policy surrenders.* In some cases, institutions have surrendered BOLI policies and incurred tax liabilities and penalties. Formal assessment of the costs and benefits of a surrender is a useful component of sound corporate governance.
- *Peer analysis of BOLI holdings.* To address reputation risk, an institution should compare its BOLI holdings relative to capital to the holdings of its peers to assess whether it is an outlier.

Liquidity Risk

Liquidity risk is the risk to earnings and capital arising from an institution's inability to meet its obligations when they come due without incurring unacceptable losses. Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure that the institution has the long-term financial flexibility to hold the asset in accordance with its expected use. The inability to hold the life insurance until the death(s) of the insured(s) when the death benefits will be collected may compromise the success of the BOLI plan. An institution generally does not receive any cash flow from the insurance until the death benefit is paid. Depending upon the age of the insured population, it is possible that an institution that insures a small number of employees may not recognize any cash flow from the insurance for many years. The illiquid nature of insurance assets, combined with the difficulty of projecting liquidity needs far into the future, is a major reason an institution should keep its BOLI holdings below the agencies' concentration guidelines. Examiners will consider an institution's BOLI holdings when assessing liquidity and assigning the liquidity component rating.

The purchase of BOLI may negatively affect an institution's liquidity position, both because BOLI is one of the least liquid assets on an institution's balance sheet, and because institutions normally fund BOLI purchases through the sale of liquid assets (*e.g.*, marketable securities). To access the CSV of BOLI, the institution must either surrender or borrow against the policy. In accordance with the policy contract and federal tax laws, the surrender of a policy may subject an institution to surrender charges, tax liabilities for previously untaxed increases in the CSV, and tax penalties. Borrowing against the CSV is disadvantageous in most cases due to limitations on the ability to deduct interest on the borrowing and other possible adverse tax consequences.

A BOLI product qualifying as a modified endowment contract (MEC) for tax purposes has particular liquidity disadvantages. If an institution surrenders a MEC, it will incur a tax liability on the increase in the policy's CSV from earnings on the policy since its inception and may incur an additional tax penalty for early surrender.

In order to avoid such additional tax penalties, an institution may opt to purchase a non-MEC contract. A non-MEC contract permits the policy owner to surrender the policy without incurring the additional tax penalty that, under certain circumstances, applies to MECs. Moreover, depending on the terms of the insurance contract, an institution generally may withdraw up to the basis (that is, the original amount invested) without creating a taxable event. However, a non-MEC policy increases in complexity if it is in the form of a separate account covered by a stable value protection (SVP) contract. An SVP contract protects the policy owner from declines in the value of the assets in the separate account arising from changes in interest rates, thereby mitigating price risk and earnings volatility. An SVP contract is most often used in connection with fixed-income investments. Institutions should recognize that SVP providers often place restrictions on the amount that may be withdrawn from the separate account, thereby reducing the liquidity of the BOLI asset. An institution considering the purchase of a non-MEC for its potential liquidity advantages compared to a MEC also should be aware of contractual provisions, such as 1035 Exchange fees and "crawl-out" restrictions,[9] which may limit such advantages.

Transaction/Operational Risk

As it applies to BOLI, transaction/operational risk is the risk to earnings and capital arising from problems caused by the institution's failure to fully understand or to properly implement a transaction. Transaction/operational risk arises due to the variety and complexity of life insurance products, as well as tax and accounting treatments. To help mitigate this risk, management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables most likely to affect product performance are the policy's interest-crediting rate, mortality cost, and other expense charges.

Transaction/operational risk is also a function of the type and design features of a life insurance contract. With a general account product, there are only two parties to the contract: the policy owner and the insurance carrier. With a separate account product, the insurance carrier has a separate contract with an investment manager. There could also be an SVP provider with whom the carrier has a separate contract.

Transaction/operational risk may also arise as a result of the variety of negotiable features associated with a separate account product. These include the investment options; the terms, conditions, and cost of SVP; and mortality options. Deferred acquisition costs (DAC) represent the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs and capitalizes the DAC, including the prepayment of taxes in accordance with federal tax law. As the carrier recovers the DAC in accordance with applicable tax law, it credits the amount to the separate account policyholder. Once it has been credited to

[9] A crawl-out restriction limits the amount of CSV eligible for a 1035 Exchange or surrender over a period of time.

the institution, the DAC is essentially a receivable from the carrier and, therefore, represents a general account credit exposure.

Separate account policies have additional transaction risks that can result from accounting requirements. Several institutions have had to restate their earnings because of contractual provisions in their policies that were ambiguous with respect to the amount of the CSV available upon surrender of the policy. Because BOLI must be carried at the amount that could be realized under the insurance contract as of the balance sheet date, if any contractual provision related to costs, charges, or reserves creates uncertainty regarding the realization of a policy's full CSV, the agencies will require an institution to record the BOLI net of those amounts. As part of an effective pre-purchase analysis, an institution should thoroughly review and understand how the accounting rules will apply to the BOLI policy it is considering purchasing.

Tax and Insurable Interest Implications

Before the purchase of BOLI and periodically thereafter, management should also explicitly consider the financial impact (*e.g.*, tax provisions and penalties) of surrendering a policy. Recent adverse press coverage of COLI should serve as a reminder to institutions that the current tax law framework, as it applies to BOLI, is always subject to legislative changes. A tax change that makes future BOLI cash flows subject to income tax, while perhaps deemed unlikely by many institutions, would have a negative impact on the economics of the BOLI holdings. An institution should recognize that earnings from BOLI could make it subject to the alternative minimum tax.

Institutions should also recognize that their actions, subsequent to purchase, could jeopardize the tax-advantaged status of their insurance holdings. The risk that a life insurance policy could be characterized by the Internal Revenue Service (IRS) as an actively managed investment is particularly relevant to separate account policies. Many larger institutions prefer separate account products because of perceived lower credit risk and greater transparency (that is, explicit disclosure of costs). Assets held by the insurance company on behalf of the policy owners in the separate account are intended to be beyond the reach of the insurance company's general creditors in the event of insolvency; however, the protected status of separate account assets is generally untested in the courts. While the separate account structure helps to mitigate an institution's credit exposure to the insurance carrier, the institution can have no "control" over investment decisions (*e.g.*, timing of investments or credit selection) in the underlying account. Generally, allocating separate account holdings across various divisions of an insurance company's portfolio does not raise concerns about "control," but other actions that a policy owner takes may be construed as investment control and could jeopardize the tax-advantaged status.

To benefit from the favorable tax treatment of insurance, a BOLI policy must be a valid insurance contract under applicable state law and must qualify under applicable federal law. Institutions must have an insurable interest in the covered employee, as set forth in applicable state laws. Furthermore, the favorable tax-equivalent yields of BOLI result only when an institution generates taxable income. Institutions that have no federal income tax liability receive only the nominal interest-crediting rate as a yield. In such an environment, BOLI loses much of its yield advantage relative to other investment alternatives.

Some institutions seem to have drawn comfort from assurances from insurance carriers that the carrier would waive lack of insurable interest as a defense against paying a claim. While the carrier may indeed make a payment, such payment may not necessarily go to the institution. Such assurances may not be sufficient to satisfy the IRS requirements for a valid insurance contract, nor do they eliminate potential claims from the estate of the insured that might seek to claim insurance proceeds on the basis that the institution lacked an insurable interest.

For example, some institutions have established out-of-state trusts to hold their BOLI assets. While such trusts may have legitimate uses, such as to gain access to an insurance carrier's product, in some cases the purpose is to avoid unfavorable insurable interest laws in the institution's home state and to domicile the policy in a state with more lenient requirements. In some cases, institutions have not made employees aware that they have taken out insurance on their lives.

A recent Fifth Circuit Court of Appeals ruling demonstrates the potential danger of this approach. A Texas employer used a Georgia trust to hold life insurance policies on its employees in Texas, and the trust agreement provided that the insurable interest law of Georgia should apply. In a lawsuit brought by the estate of a deceased employee, the court ignored this provision because the insured employee was not a party to the trust agreement. It then found that the insurable interest law of Texas applied and under that state's law, the employer did not have an insurable interest in the employee. The result was that the employer was not entitled to the insurance death benefits.[10] The outcome in this case suggests that institutions that have used, or are considering using, an out-of-state trust to take advantage of more favorable insurable interest laws in another state should assess whether they could be vulnerable to a similar legal challenge.

Institutions should have appropriate legal review to help ensure compliance with applicable tax laws and state insurable interest requirements. Institutions that insure employees for excessive amounts may be engaging in impermissible speculation or unsafe and unsound banking practices. The agencies may require institutions to surrender such policies.

Reputation Risk

Reputation risk is the risk to earnings and capital arising from negative publicity regarding an institution's business practices. While this risk arises from virtually all bank products and services, reputation risk is particularly prevalent in BOLI because of the potential perception issues associated with an institution's owning or benefiting from life insurance on employees.

A well-managed institution will take steps to reduce the reputation risk that may arise as a result of its BOLI purchases, including maintaining appropriate documentation evidencing informed consent by the employee, prior to purchasing insurance. Some institutions assert that they make employees aware via employee handbooks, manuals, or newsletters of the possibility that the institution may acquire life insurance on them. Although such disclosure may satisfy state insurance requirements, any approach that does not require formal employee consent may significantly increase an institution's reputation risk.

Some institutions have begun to purchase separate account, non-MEC product designs in order to address the liquidity concerns with MEC policies. One consequence of this product design choice, however, is that it has become increasingly common for institutions to insure a very large segment of their employee base, including non-officers. Because non-MEC designs have a

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[10] *Mayo v. Hartford Life Insurance Company*, 354 F.3d 400 (5th Cir. 2004).

higher ratio of death benefit to premium dollar invested, some institutions have, therefore, taken out very high death benefit policies on employees, including lower-level employees, further adding to reputation risk and highlighting the importance of obtaining explicit consent.

Credit Risk

Credit risk is the potential impact on earnings and capital arising from an obligor's failure to meet the terms of any contract with the institution or otherwise perform as agreed. All life insurance policyholders are exposed to credit risk. The credit quality of the insurance company and duration of the contract are key variables. With insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured, and if applicable, from the carrier's obligation to pay the CSV (less any applicable surrender charges) upon the surrender of the policy.

Most BOLI products have very long-term (30- to 40-year) expected time frames for full collection of cash proceeds, *i.e.*, the death benefit. For general account policies, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. Institutions record and carry this claim against the insurance company as an asset.

Before purchasing BOLI, an institution should conduct an independent financial analysis of the insurance company and continue to monitor its condition on an ongoing basis. The institution's credit risk management function should participate in the review and approval of insurance carriers. As with lending, the depth and frequency of credit analysis (both initially and on an ongoing basis) should be a function of the relative size and complexity of the transaction and the size of outstanding exposures. Among other things, an institution should consider its legal lending limit, concentration guidelines (generally defined as the aggregate of direct, indirect, and contingent obligations and exposures that exceed 25 percent of the institution's capital), and any applicable state restrictions on BOLI holdings when assessing its broader credit risk exposure to insurance carriers. To measure credit exposures comprehensively, an institution should aggregate its exposures to individual insurance carriers, and the insurance industry as a whole, attributable to both BOLI policies and other credit relationships (*e.g.*, loans and derivatives exposures).

There are product design features of a BOLI policy that can reduce credit risk. As noted earlier, an institution can purchase separate account products, where the institution assumes the credit risk of the assets held in the separate account, rather than the direct credit risk of the carrier as would be the case in a general account policy. With separate account policies, the insurance carrier owns the assets, but maintains the assets beyond the reach of general creditors in the event of the insurer's insolvency. However, even with a separate account policy, the policy owner incurs some general account credit risk exposure to the insurance carrier associated with the carrier's mortality and DAC reserves. Amounts equal to the mortality and DAC reserves are owed to the policyholder and represent general account obligations of the insurance carrier. In addition, the difference, if any, between the CSV and the minimum guaranteed death benefit would be paid out of the insurance carrier's general account.

A separate account policy may have an SVP contract issued by the insurance carrier or by a third party that is intended to protect the policyholder from most declines in fair value of separate account assets. In general, the provider of an SVP contract agrees to pay any shortfall between the fair value of the separate account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. Under most arrangements, the insurance carrier is not responsible for making a payment under the SVP contract if a third-party protection provider fails to make a required payment to it. The SVP contract thus represents an additional source of credit risk for a separate account product. The policyholder's exposure under an SVP contract is to both the protection provider, which must make any required payment to the insurance carrier, and the carrier, which must remit the payment received from the protection provider to the institution. Because of this exposure, an institution should also evaluate the repayment capacity of the SVP provider.

State insurance regulation governing reserve requirements for insurance carriers, state guaranty funds, and reinsurance arrangements help to reduce direct credit risks from general account exposures. Further, an institution can use a 1035 Exchange to exit a deteriorating credit exposure, although most policies impose fees for the exchange. While credit risk for existing general and separate account policies may be low currently, the extremely long-term nature of a BOLI policy underscores the fact that credit risk remains an important risk associated with life insurance products. Strong current credit ratings offer no guarantee of strong credit ratings 20, 30, or 40 years into the future.

Interest Rate Risk

Interest rate risk is the risk to earnings and capital arising from movements in interest rates. Due to the interest rate risk inherent in general account products, it is particularly important that management fully understand how these products expose the policyholder to interest rate risk before purchasing the policy. The interest rate risk associated with these products is primarily a function of the maturities of the assets in the carrier's investment portfolio, which often range from 4 to 8 years. When purchasing a general account policy, an institution chooses one of a number of interest-crediting options (that is, the method by which the carrier will increase the policy's CSV). Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the carrier's portfolio each year. Using the "new money" crediting rate, the institution earns a return based upon yields available in the market at the time it purchases the policy.

Separate account products may also expose the institution to interest rate risk, depending on the types of assets held in the separate account. For example, if the separate account assets consist solely of U.S. Treasury securities, the institution is exposed to interest rate risk in the same way as holding U.S. Treasury securities directly in its investment portfolio. However, because the institution cannot control the separate account assets, it is more difficult for the institution to control this risk. Accordingly, before purchasing a separate account product, an institution's management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent within the separate account and ensure that the risk is appropriate for the institution. The institution also should establish monitoring and reporting systems that will enable management to monitor and respond to interest rate fluctuations and their effect on separate account assets.

Compliance/Legal Risk

Compliance/legal risk is the risk to earnings and capital arising from violations of, or nonconformance with, laws, rulings, regulations, prescribed practices, or ethical standards. Failure to comply with applicable laws, rulings, regulations, and prescribed practices could compromise the success of a BOLI program and result in fines or penalties imposed by regulatory authorities or loss of tax benefits. Among the legal and regulatory considerations that an institution should evaluate are compliance with state insurable interest laws; the Employee Retirement Income Security Act of 1974 (ERISA); Federal Reserve Regulations O and W (12 CFR 215 and 223, respectively); the Interagency Guidelines Establishing Standards for Safety and Soundness; the requirements set forth under the Legal Authority section of this document; and federal tax regulations applicable to BOLI.

Tax benefits are critical to the success of most BOLI plans. Accordingly, an institution owning separate account BOLI must implement internal policies and procedures to ensure that it does not take any action that might be interpreted as exercising "control" over separate account assets. This is especially important for privately placed policies in which the institution is the only policyholder associated with the separate account assets.

When purchasing BOLI, institutions should be aware that the splitting of commissions between a vendor and the institution's own subsidiary or affiliate insurance agency presents compliance risk. The laws of most states prohibit the payment of inducements or rebates to a person as an incentive for that person to purchase insurance. These laws may also apply to the person receiving the payment. When an insurance vendor splits its commission with an institution's insurance agency that was not otherwise involved in the transaction, such a payment may constitute a prohibited inducement or rebate. Accordingly, an institution should assure itself that this practice is permissible under applicable state law and in compliance with Federal Reserve Regulation W before participating in any such arrangement. Moreover, payments to an affiliate that did not perform services for the institution could also raise other regulatory and supervisory issues.

Due to the significance of the compliance risk, institutions should seek the advice of counsel on these legal and regulatory issues.

Price Risk

Price risk is the risk to earnings and capital arising from changes in the value of portfolios of financial instruments. Accounting rules permit owners of insurance contracts to account for general account products using an approach that is essentially based on cost plus accrued earnings. However, for separate account products without SVP, the accounting would largely be based on the fair value of the assets held in the account because this value is the amount that could be realized from the separate account if the policy is surrendered. (See Accounting Considerations above.) Typically, the policyholder of separate account products assumes all price risk associated with the investments within the separate account. Usually, the insurance carrier will provide neither a minimum CSV nor a guaranteed interest-crediting rate for separate account products. Absent an SVP contract, the amount of price risk generally depends upon the type of assets held in the separate account.

Because the institution does not control the separate account assets, it is more difficult for it to control the price risk of these assets than if they were directly owned. To address income statement volatility, an institution may purchase an SVP contract for its separate account policy. The SVP contract is designed to ensure that the amount that an institution could realize from its separate account policy, in most circumstances, remains at or above the cost basis of the separate account to the policyholder. Institutions should understand, however, that SVP contracts protect against declines in value attributable to changes in interest rates; they do not cover default risk. Moreover, one purpose of the SVP contract is to reduce volatility in an institution's reported earnings. To realize any economic benefit of the SVP contract, an institution would have to surrender the policy. Since policy surrender is nearly always an uneconomic decision, the SVP contract provides, in a practical sense, accounting benefits only.

Before purchasing a separate account life insurance product, management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent in the separate account and ensure that the risk is appropriate. If the institution does not purchase SVP, management should establish monitoring and reporting systems that will enable it to recognize and respond to price fluctuations in the fair value of separate account assets.

Under limited circumstances it is legally permissible for an institution to purchase an equity-linked variable life insurance policy if the policy is an effective economic hedge against the institution's equity-linked obligations under employee benefit plans.[11] An effective economic hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instrument. Such a relationship would exist where the obligation under an institution's deferred compensation plan is based upon the value of a stock market index and the separate account contains a stock mutual fund that mirrors the performance of that index. Institutions need to be aware that this economic hedge may not qualify as a hedge for accounting purposes. Thus, the use of equity-linked variable life insurance policies to economically hedge equity-linked obligations may not have a neutral effect on an institution's reported earnings.

Unlike separate account holdings of debt securities, SVP contracts on separate account equity holdings are not common. The economic hedging criteria for equity-linked insurance products lessens the effect of price risk because changes in the amount of the institution's equity-linked liability are required to offset changes in the value of the separate account assets. If the insurance cannot be characterized as an effective economic hedge, the presence of equity securities in a separate account is impermissible, and the agencies will require institutions to reallocate the assets unless retention of the policy is permitted under federal law.[12]

In addition to the general considerations discussed previously, which are applicable to any separate account product, an institution should perform further analysis when purchasing a separate account product involving equity securities. At a minimum, the institution should:

1. Compare the equity-linked liability being hedged (*e.g.*, deferred compensation) and the equity securities in the separate account. Such an analysis considers the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.

2. Determine a target range for the hedge effectiveness ratio (*e.g.*, 95 to 105 percent) and establish a method for measuring hedge effectiveness on an ongoing basis. The institution should establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.

[11] Insured state banks and state savings associations may make such purchases only if permitted to do so under applicable state law.

[12] Insured state banks and state savings associations may request the FDIC's consent to retain the policies, but consent will not be granted if it is determined that retaining the policies presents a significant risk to the appropriate insurance fund.

3. Establish a process for analyzing and reporting to management and the board the effect of the hedge on the institution's earnings and capital ratios. The analysis usually considers results both with and without the hedging transaction.

RISK-BASED CAPITAL TREATMENT

If an institution owns a general account insurance product, it should apply a 100 percent risk weight to its claim on the insurance company for risk-based capital purposes. A BOLI investment in a separate account insurance product, however, may expose the institution to the market and credit risks associated with the pools of assets in the separate account. The assets in a pool may have different risk weights, similar to the assets held in a mutual fund in which an institution has invested. For risk-based capital purposes, if an institution can demonstrate that the BOLI separate account policy meets the requirements below, it may choose to "look-through" to the underlying assets to determine the risk weight.

Criteria for a Look-Through Approach

To qualify for the "look-through" approach, separate account BOLI assets must be protected from the insurance company's general creditors in the event of the insurer's insolvency. An institution should document its assessment, based upon applicable state insurance laws and other relevant factors, that the separate account assets would be protected from the carrier's general creditors. If the institution does not have sufficient information to determine that a BOLI separate account policy qualifies for the look-through approach, the institution must apply the standard risk weight of 100 percent to this asset.

In addition, when an institution has a separate account policy, the portion of the carrying value of the institution's insurance asset that represents general account claims on the insurer, such as DAC and mortality reserves that are realizable as of the balance sheet date, and any portion of the carrying value attributable to an SVP contract, are not eligible for the look-through approach. These amounts should be risk weighted at the 100 percent risk weight applicable to claims on the insurer or the SVP provider, as appropriate.

Look-Through Approaches

When risk weighting a qualifying separate account policy, an institution may apply the highest risk weight for an asset permitted in the separate account, as stated in the investment agreement, to the entire carrying value of the separate account policy, except for any portions of the carrying value that are general account claims or are attributable to SVP. In no case, however, may the risk weight for the carrying value of the policy (excluding any general account and SVP portions) be less than 20 percent.

Alternatively, an institution may use a pro-rata approach to risk weighting the carrying value of a qualifying separate account policy (excluding any general account and SVP portions). The pro-rata approach is based on the investment limits stated in the investment agreement for each class of assets that can be held in the separate account, with the constraint that the weighted average risk weight may not be less than 20 percent. If the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, the institution must use the highest risk weight for the maximum amount permitted in that asset class, and then proceed to the next highest risk weight until the permitted amounts equal 100 percent.

For example, if a separate account investment agreement permits a maximum allocation of 60 percent for corporate bonds, 40 percent for U.S. government-sponsored enterprise debt securities, and 60 percent for U.S. Treasury securities, then the institution must risk weight 60 percent of the carrying value of the separate account investment (excluding any portion attributable to SVP) at the 100 percent risk weight applicable to corporate bonds and the remaining 40 percent at the 20 percent risk weight for U.S. government-sponsored enterprise debt securities. Because the sum of the permitted allocation for corporate bonds and government-sponsored enterprise debt securities totals 100 percent, the institution cannot use the zero percent risk weight for U.S. Treasury securities. However, if the permitted allocation for U.S. government-sponsored enterprise debt securities was 30 percent rather than 40 percent, the institution could risk weight the remaining 10 percent of the carrying value of its investment at the zero percent risk weight for U.S. Treasuries.

Regardless of the look-through approach an institution employs, the weighted average risk weight for the separate account policy (excluding any general account and SVP portions) may not be less than 20 percent, even if all the assets in the separate account would otherwise qualify for a zero percent risk weight. Furthermore, the portion of the carrying value of the separate account policy that represents general account claims on the insurer, such as realizable DAC and mortality reserves, and any portion of the carrying value attributable to an SVP contract, should be risk weighted at the risk weight applicable to the insurer or the SVP provider, as appropriate.

The following example demonstrates the appropriate risk-weight calculations for the pro-rata approach, incorporating the components of a BOLI separate account policy that includes general account claims on the insurer as well as the investment allocations permitted for different asset classes in the separate account investment agreement.

EXAMPLE: The separate account investment agreement requires the account to hold a minimum of 10 percent in U.S. Treasury obligations. It also imposes a maximum allocation of 50 percent in mortgage-backed securities issued by U.S. government-sponsored enterprises, and a maximum allocation of 50 percent in corporate bonds. Assume that the portion of the carrying value of the separate account policy attributable to realizable DAC and mortality reserves equals $10 and that the portion attributable to the SVP totals $10.

Carrying Value of Separate Account Policy	$100.00
Less: Portion Attributable to DAC and Mortality Reserves	10.00
Portion Attributable to SVP	10.00
Net Carrying Value of separate account policy available for pro-rata	$80.00
Risk weight calculation:	
U.S. Treasury @ 10% x $80 = $8 x 0% RW	0.00
Corporate Bonds @ 50% x $80 = $40 x 100% RW	$40.00
GSE MBS @ 40% x $80 = $32 x 20% RW	6.40
Separate account risk-weighted assets subject to pro-rata	$46.40
Add Back: DAC and Mortality Reserves = $10 x 100% RW	$10.00
Add Back: SVP = $10 x 100% RW	10.00
General account and SVP risk-weighted assets	$20.00
Total BOLI-related risk-weighted assets	$66.40

SUMMARY

The purchase of BOLI can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits. Consistent with safe and sound banking practices, institutions must understand the risks associated with this product and implement a risk management process that provides for the identification and control of such risks. A sound pre-purchase analysis, meaningful ongoing monitoring program, reliable accounting process and accurate assessment of risk-based capital requirements are all components of the type of risk management process the agencies expect institutions to employ.

Where an institution has acquired BOLI in an amount that approaches or exceeds agency concentration levels, examiners will more closely scrutinize the components of the risk management process and the institution's associated documentation. Where BOLI has been purchased in an impermissible manner, ineffective controls over BOLI risks exist, or a BOLI exposure poses a safety and soundness concern, the appropriate agency may take supervisory action, including requiring the institution to divest affected policies, irrespective of tax consequences.

APPENDIX

COMMON TYPES OF LIFE INSURANCE

Life insurance can be categorized into two broad types: temporary (also called "term") insurance and permanent insurance. There are numerous variations of these products. However, most life insurance policies fall within one (or a combination) of the following categories.

Temporary (Term) Insurance

Temporary (term) insurance provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection. Term insurance premiums do not have a savings component; thus, term insurance does not create CSV.

Permanent Insurance

In contrast to term insurance, permanent insurance is intended to provide life insurance protection for the entire life of the insured, and its premium structure includes a savings component. Permanent insurance policy premiums typically have two components: the insurance component (*e.g.*, mortality cost, administrative fees, and sales loads) and the savings component. Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk.

The savings component typically is referred to as CSV. The policyholder may use the CSV to make the minimum premium payments necessary to maintain the death benefit protection and may access the CSV by taking out loans or making partial surrenders. If permanent insurance is surrendered before death, surrender charges may be assessed against the CSV. Generally, surrender charges are assessed if the policy is surrendered within the first 10 to 15 years.

Two broad categories of permanent insurance are:

- Whole Life – A traditional form of permanent insurance designed so that fixed premiums are paid for the entire life of the insured. Death benefit protection is provided for the entire life of the insured, assuming all premiums are paid.

- Universal Life – A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high CSV. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other insurance charges.

PURPOSES FOR WHICH INSTITUTIONS COMMONLY PURCHASE LIFE INSURANCE

Key Person

Institutions often purchase life insurance to protect against the loss of "key persons" whose services are essential to the continuing success of the institution and whose untimely death would be disruptive. For example, an institution may purchase insurance on the life of an employee or director whose death would be of such consequence to the institution as to give it an insurable interest in his or her life. The determination of whether an individual is a key person does not turn on that individual's status as an officer or director, but on the nature of the individual's economic contribution to the institution.

The first step in indemnifying an institution against the loss of a key person is to identify the key person. The next and possibly most difficult step is estimating the insurable value of the key person or the potential loss of income or other value that the institution may incur from the untimely death of that person.

Because the most appropriate method for determining the value of a key person is dependent upon individual circumstances, the agencies have not established a formula or a specific process for estimating the value of a key person. Instead, the agencies expect institutions to consider and analyze all relevant factors and use their judgment to make a decision about the value of key persons.

Key person life insurance should not be used in place of, and does not diminish the need for, adequate management succession planning. Indeed, if an institution has an adequate management succession plan, its reliance on a key person should decline as the person gets closer to retirement.

Financing or Cost Recovery for Benefit Plans

Like other businesses, institutions often use life insurance as a financing or cost recovery vehicle for pre- and post-retirement employee benefits, such as individual or group life insurance, health insurance, dental insurance, vision insurance, tuition reimbursement, deferred compensation, and pension benefits.

Permanent insurance is used for this purpose. In these arrangements, an institution insures the lives of directors or employees in whom it has an insurable interest to reimburse the institution for the cost of employee benefits. The group of insured individuals may be different from the group that receives benefits. The institution's obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. The life insurance purchased by the institution remains an asset even after the employer's relationship with an insured employee is terminated. The employees who receive benefits, whether insured or not, have no ownership interest in the insurance (other than their general claim against the institution's assets arising from the institution's obligation to provide the stated employee benefits).

There are two common methods of financing employee benefits through the purchase of life insurance. The first is the cost recovery method, which usually involves present value analysis. Typically, the institution projects the amount of the expected benefits owed to employees and then discounts this amount to determine the present value of the benefits. Then, the institution purchases a sufficient amount of life insurance on the lives of certain employees so that the gain (present value of the life insurance proceeds less the premium payments) from the insurance proceeds reimburses the institution for the benefit payments. Under this method, the institution absorbs the cost of providing the employee benefits and the cost of purchasing the life insurance. The institution holds the life insurance and collects the death benefit to reimburse the institution for the cost of the employee benefits and the insurance.

The second method of financing employee benefits is known as cost offset. With this method, the institution projects the annual employee benefit expense associated with the benefit plan. Then, the institution purchases life insurance on the lives of certain employees. The amount earned on the CSV each year should not exceed the annual benefit expense.

Split-Dollar Life Insurance Arrangements

Institutions sometimes use split-dollar life insurance arrangements to provide retirement benefits and death benefits to certain employees as part of their compensation. Under split-dollar arrangements, the employer and the employee share the rights to the policy's CSV and death benefits. The employer and the employee may also share premium payments. If the employer pays the entire premium, the employee may need to recognize taxable income each year in accordance with federal income tax regulations.

Split-dollar arrangements may be structured in a number of ways. The two most common types of split-dollar arrangements are:

- Endorsement Split-Dollar – The employer owns the policy and controls all rights of ownership. The employer provides the employee an endorsement of the portion of the death benefit specified in the plan agreement with the employee. The employee may designate a beneficiary for the designated portion of the death benefit. Under this arrangement, the employer typically holds the policy until the employee's death. At that time, the employee's beneficiary receives the designated portion of the death benefits, and the employer receives the remainder of the death benefits.

- Collateral Assignment Split-Dollar – The employee owns the policy and controls all rights of ownership. Under these arrangements, the employer usually pays the entire premium or a substantial part of the premium. The employee assigns a collateral interest in the policy to the employer that is equal to the employer's interest in the policy. The employer's interest in the policy is set forth in the split-dollar agreement between the employer and the employee. Upon retirement, the employee may have an option to buy the employer's interest in the insurance policy. This transfer of the employer's interest to the employee is typically referred to as a "roll-out." If a "roll-out" is not provided or exercised, the employer does not receive its interest in the policy until the employee's death.

Split-dollar life insurance is a very complex subject that can have unforeseen tax and legal consequences. Internal Revenue Service regulations issued in 2003[13] govern the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17,

[13] 68 Fed. Reg. 54336 (Sept. 17, 2003), chiefly codified at 26 CFR 1.61-22 and 1.7872-15.

2003.[14] These rules provide less favorable tax treatment to split-dollar arrangements than existed previously. Institutions considering entering into a split-dollar life insurance arrangement should consult qualified tax, insurance, and legal advisors.

Life Insurance on Borrowers

State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. In some states, the lender's insurable interest may equal the borrower's obligation plus the cost of insurance and the time value of money. Institutions are permitted to protect themselves against the risk of loss from the death of a borrower. This protection may be provided through self-insurance, the purchase of debt cancellation contracts, or by the purchase of life insurance policies on borrowers.

Institutions can take two approaches in purchasing life insurance on borrowers. First, an institution can purchase life insurance on an individual borrower for the purpose of protecting the institution specifically against loss arising from that borrower's death. Second, an institution may purchase life insurance on borrowers in a homogenous group of loans employing a cost recovery technique similar to that used in conjunction with employee benefit plans. Under this method, the institution insures the group of borrowers for the purpose of protecting the institution from loss arising from the death of any borrower in the homogenous pool. Examples of homogenous pools of loans include consumer loans that have distinctly similar characteristics, such as automobile loans, credit card loans, and residential real estate mortgages.

When purchasing insurance on an individual borrower, an institution should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to structure the insurance policy in a manner consistent with the expected repayment of the borrower's loan. To accomplish this, management should estimate the risk of loss over the life of the loan and match the anticipated insurance proceeds to the risk of loss. Generally, the risk of loss will be closely related to the outstanding principal of the debt. The insurance policy should be structured so that the expected insurance proceeds never substantially exceed the risk of loss.

When purchasing life insurance on borrowers in a homogenous pool of loans, an institution's management should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to match the insurance proceeds on an aggregate basis to the total outstanding loan balances. If allowed by state law, institutions may match the insurance proceeds to the outstanding loan balances plus the cost of insurance on either a present value or future value basis. This relationship should be maintained throughout the duration of the program.

The purchase of life insurance on a borrower is not an appropriate mechanism for effecting a recovery on an obligation that has been charged off, or is expected to be charged off, for reasons other than the borrower's death. In the case of a charged-off loan, the purchase of life insurance on the borrower does not protect the institution from a risk of loss since the loss has already occurred. Therefore, the institution does not need to purchase insurance. Acquiring insurance that an institution does not need may subject the institution to unwarranted risks, which would be an unsafe and unsound banking practice. In the case of a loan that the institution expects to charge off for reasons other than the borrower's death, the risk of loss is so pronounced that the

[14] Split-dollar arrangements entered into prior to September 17, 2003, and not materially modified thereafter may be treated differently.

purchase of life insurance by the institution at that time would be purely speculative and an unsafe and unsound banking practice.

Internal Revenue Code Section 264(f) disallows a portion of an institution's interest deduction for debt incurred to purchase life insurance on borrowers. Institutions considering the purchase of insurance on borrowers should consult their tax advisors to determine the economic viability of this strategy.

Life Insurance as Security for Loans

Institutions sometimes take an interest in an existing life insurance policy as security for a loan. Institutions also make loans to individuals to purchase life insurance, taking a security interest in the policy, a practice known as "insurance premium financing." As with any other type of lending, extensions of credit secured by life insurance should be made on terms that are consistent with safe and sound banking practices. For instance, the borrower should be obligated to repay the loan according to an appropriate amortization schedule.

Generally, an institution may not rely on its security interest in a life insurance policy to extend credit on terms that excuse the borrower from making interest and principal payments during the life of the borrower with the result that the institution is repaid only when the policy matures upon the death of the insured. Lending on such terms is generally speculative and an unsafe and unsound banking practice.

Institutions may acquire ownership of life insurance policies for debts previously contracted (DPC) by invoking their security interest in a policy after a borrower defaults. Consistent with safety and soundness, institutions should use their best efforts to surrender or otherwise dispose of permanent life insurance acquired for DPC at the earliest reasonable opportunity.[15] In the case of temporary insurance acquired for DPC, retention until the next renewal date or the next premium date, whichever comes first, will be considered reasonable.

[15] The OCC has generally directed national banks to surrender or divest permanent life insurance acquired for DPC within 90 days of obtaining control of the policy.

GLOSSARY

Cash Surrender Value (CSV) – The value available to the policyholder if the policy is surrendered. If no loans are outstanding, this amount is generally available in cash. If loans have been made, the amount available upon surrender is equal to the cash surrender value less the outstanding loan (including accrued interest).

Deferred Acquisition Costs (DAC) – DAC represents the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs. Carriers capitalize DAC and recover them in accordance with applicable tax law. As the carrier recovers DAC, it credits the amount to the policyholder.

Experience-Rated Pricing – A pricing method that bases prices for insurance products on the actual expenses and claims experience for the pool of individuals being insured.

General Account – A design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policy's CSV.

Interest-Crediting Rate – The gross yield on the investment in the insurance policy, that is, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value.

There are a number of crediting rates, including "new money" and "portfolio." Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the insurance carrier's portfolio each year. Using the "new money" crediting rate, the institution will earn a return based upon yields available in the market at the time it purchases the policy.

Modified Endowment Contract (MEC) – Type of policy that is defined in Internal Revenue Code Section 7702A. A MEC generally involves the payment of a single premium at the inception of the contract; thus, it fails the so-called seven-pay test set forth in the statute. MECs are denied some of the favorable tax treatment usually accorded to life insurance. For example, most distributions, including loans, are treated as taxable income. An additional 10 percent penalty tax also is imposed on distributions in some circumstances. However, death benefits remain tax-free.

Mortality Charge – The pure cost of the life insurance death benefit within a policy. It represents a cost to the purchaser and an income item to the carrier. Mortality charges retained by the insurance carrier are used to pay claims.

Mortality Reserve – In separate account products, the mortality reserve represents funds held by an insurance carrier outside of the separate account to provide for the payment of death benefits.

Non-MEC – An insurance contract that is not categorized as a MEC under Internal Revenue Code Section 7702A.

Separate Account – A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's CSV is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder neither owns the underlying separate account nor controls investment decisions (*e.g.*, timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

Seven-Pay Test – The seven-pay test is a test set forth in Internal Revenue Code Section 7702A that determines whether or not a life insurance product is a MEC for federal tax purposes.

Split-Dollar Life Insurance – A split-dollar life insurance arrangement splits the policy's premium and policy benefits between two parties, usually an employer and employee. The two parties may share the premium costs while the policy is in effect, pursuant to a prearranged contractual agreement. At the death of the insured or the termination of the agreement, the parties split the policy benefits or proceeds in accordance with their agreement.

Stable Value Protection (SVP) Contracts – In general, an SVP contract pays the policy owner of a separate account any shortfall between the fair value of the separate account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. The cost basis of the separate account typically would take into account the fair value of the assets in the account when the policy was initially purchased, the initial fair value of assets added to the account thereafter, interest credited to the account, the amount of certain redemptions and withdrawals from the account, and credit losses incurred on separate account assets. Thus, SVP contracts mitigate price risk. SVP contracts are most often used in connection with fixed-income investments.

1035 Exchange – A tax-free replacement of an insurance policy for another contract covering the same person(s) in accordance with Section 1035 of the Internal Revenue Code.

Variable Life Insurance –Variable life insurance policies are investment-oriented life insurance policies that provide a return linked to an underlying portfolio of securities. The portfolio typically is a group of mutual funds chosen by the insurer and housed in a separate account, with the policyholder given some discretion in choosing among the available investment options.

Credit Union Department

REGULATORY BULLETIN

April 28, 2014 RB 2014-01

Guidance on Direct Loan Referral Programs

Introduction

This guidance reminds credit unions of the process they should follow to prudently manage the risks associated with direct loans based on a referral from an independent dealer. While there are benefits to a well-run loan referral program, an improperly managed or loosely controlled program can quickly lead to unintended risk exposure. This can increase credit risk, liquidity risk, transaction risk, compliance risk, and reputation risk. It takes proper planning and appropriate controls and monitoring to make this type of program profitable and a productive activity for serving members.

Background

During periods of reduced net interest margins, stagnant growth in traditional loan products, and increased competition, credit union management and directors face many challenges in seeking to improve the credit union's financial performance. Engaging in new or modified credit union products or services is often considered a solution. However, if management and the board are overly focused on expected returns, do not have a good understanding of the inherent risk, or have poor governance practices, the credit union's ability to effectively measure, monitor, and control the risks inherent in such products or services may be compromised.

Recently, the Department has seen credit unions that have not performed the necessary up-front analysis to determine whether a loan referral program offers the appropriate risk-versus-return profile, and is consistent with the credit union's strategic direction. Additionally, some credit unions have failed to implement appropriate risk management controls and processes. In some cases, these oversight failures have resulted in costly errors, unwarranted risk exposure, and deviations from the credit union's business plan. Some historically well-managed credit unions have found themselves faced with problems because credit union management underestimated its need to manage, monitor, and control the development and implementation of a program. Instead of boosting net income, the product or service caused systems and control problems, resulting in credit losses, compliance issues, litigation exposure, unfavorable returns, and diminished reputation in the community.

Loan Referral Program

In broad terms, a direct loan referral program occurs as a result of a credit union setting up a direct referral relationship with a properly licensed dealer. The dealer refers members or potential members to obtain a loan directly from the credit union to purchase a vehicle (automobile, recreational vehicle, boat, motorcycle, etc.) from the dealer. Depending on the specifics of a given program, the dealer may or may not receive compensation for this referral activity; however, the credit union controls the entire credit extension process (underwriting) from the initial loan application to the credit investigation, to the new member visiting the credit union to open their account and close the loan.

Field of Membership

A credit union may only make loans to its members, and, as such, direct loan referral applicants must meet the field of membership requirements included in the credit union's bylaws and must become members of the credit union. Evidence of the prospective borrower opening a credit union membership account must be retained, along with all other pertinent documentation. As a reminder, credit unions must obtain all necessary information and follow all procedures for opening accounts as required under applicable law, including the Bank Secrecy Act, as amended by the USA PATRIOT Act, its implementing regulations, and any directives that may be issued. These requirements are in addition to the documents and disclosures required to be given or completed in conjunction with the loan transaction.

Sound Business Practices

The Department expects credit union management and the board to oversee all new, expanded, or modified products and services through an effective risk management process. An effective risk management process includes: (1) performing adequate due diligence prior to introducing the product or service, (2) developing and implementing controls and processes to ensure risk are properly measured, monitored, and controlled, and (3) developing and implementing appropriate performance monitoring and review systems. The formality of the credit union's risk management process should reflect the size of the credit union and the complexity of the product or service offered.

Credit unions should also take measures to ensure careful review and understanding of any contract or legal issues relevant to a dealer referral program. It is prudent to seek qualified legal counsel to review dealer arrangements and contracts.

Due Diligence

Prior to entering into any direct loan referral program, credit union management and the board should conduct due diligence to ensure they have a realistic understanding of the risks and rewards of the program. In addition, a credit union should conduct sufficient due diligence to determine whether it wishes to be associated with the quality of vehicles, services, and business practices of the dealer. The due diligence process should also include developing viable alternatives, including an exit strategy, in the event the referral program fails to perform as expected. Also, the credit union should determine whether the dealer has the necessary licenses to operate. NCUA Letter to Credit Unions 07-CU-13 titled "Evaluating Third Party Relationships" provides pertinent information on effective third party due diligence.

Analyze Impact on Net Worth

It is the Department's position that sound business practices for direct loan referral program requires a credit union to assess the potential risk to its net worth by analyzing appropriate factors, including:

- The interest rate that will be charged;
- Delinquencies and charge-offs;
- Loan prepayments;
- Insurance premium;
- Program fee; and
- Other costs, such as for due diligence.

Estimating how all these factors interrelate is complex, particularly for a direct loan referral program. Be aware that when a credit union has evaluated all these factors the expected return may be negative. This is the risk to net worth.

Policies and Procedures

Successful lending programs rely on well developed policies and practices. The credit union's direct loan referral policy should establish specific underwriting standards and clear requirements for direct loans based upon a dealer referral.

These lending standards should be consistent with the credit union's internal loan underwriting standards. The standards should be reviewed at least annually or more often if risk levels increase or if negative trends begin to surface.

The board and management should also develop detailed policy guidance sufficient to outline expectations and limit risks originating from this program. Policies and procedures should outline staff responsibilities and authorities for the referral processes and program oversight. Additionally, policy guidance should define the content and frequency of reporting to the board. Credit unions should also establish program limitations to control the pace of program growth and allow time to develop experience with the program. For example, some of the primary considerations a credit union should consider with respect to direct loan referral program are:

1. Total dollar limits on the program (i.e. set the limit in relationship to net worth, total loans, etc.);
2. Maximum growth limits;
3. Minimum credit score limits;
4. Minimum debt-to-income ratio limits;
5. Maximum loan-to-value ratio limits;
6. Maximum exposure from any one dealer;
7. Verification of the condition and market value of the vehicle;
8. Acceptable age of vehicles taken as collateral;
9. Acceptable maturities for direct loan referrals;
10. Pricing to reflect all costs related to the program;
11. Prohibition on the dealer receiving borrower's loan payments;
12. Prohibition on the dealer making payment on behalf of the borrower;
13. Prohibition on any credit union staff or official from, directly or indirectly, receiving consideration for the credit union making a specific loan;
14. Permissibility of selling any repossessed vehicle back to a dealer;
15. Verification of sale price;
16. Insurance requirements; and
17. Lien perfection.

Customer Service Complaints

Credit unions should also have plans to respond to member complaints, including those regarding the quality of the vehicles or services provided by the dealer. The plan also should address how the credit union will address complaints regarding false or misleading advertising, or other alleged misconduct by the dealer.

Dealer relationships that do not meet the expectations of the credit union's members expose the credit union to reputation risk. Poor service, inappropriate sales tactics, and violations of laws can result in negative perceptions in the community. Publicity about adverse events surrounding the dealer also may increase the credit union's reputation risk.

Performance Monitoring

Credit union management and the board should have appropriate performance and monitoring systems in place to allow them to assess whether the program is meeting operational and strategic expectations. The Department expects that these systems will track each dealer regarding:

1. Number of applications submitted, approved, conditioned, and denied;
2. Total loans outstanding;
3. Delinquency;
4. First payment defaults;
5. Repossessions;
6. Charge-offs;
7. Average loan to value;
8. Average loan term; and
9. Average credit score.

The board should be provided information pertaining to the program (i.e. loans processed, approved, rejected, booked, delinquency, repossessions, etc.) on a periodic basis.

Summary

When a credit union engages in any lending activity, it should be compatible with a credit union's risk tolerance, administrative capabilities, and strategic goals. The projected and realized impact on a credit union's financial performance should be analyzed regularly. Reasonable program limits should be established as well as on-going program monitoring and analysis.

Examiners will assess whether a credit union involved in direct loan referral programs has adequately planned for, and is monitoring and controlling this activity. Management will be adversely rated for a failure to manage and control this type of lending.

Credit Union Department

REGULATORY BULLETIN

July 31, 2014 RB 2014-02

Guidance on Temporary Mortgage Purchase Programs

Background

Some credit unions have become involved in the temporary funding of residential mortgage loans awaiting sale to the secondary market. This may be done through a traditional line of credit to the originating mortgage company or the temporary purchase of the loans from the mortgage company. This Bulletin is only directed toward the latter activity, for which limited guidance is available. Temporary purchase programs generally present greater risk to the credit union than a warehouse line of credit due to the more direct loss exposure and higher volume of activity. This higher volume of activity, when combined with an otherwise minor deficiency or control weakness, can represent a substantial threat to credit union capital if left undetected or uncorrected. Therefore, the board of directors of any credit union operating a temporary purchase program must demonstrate heightened awareness and supervision to avoid undue risks to capital.

Overview of Activity

"Temporary mortgage purchase program" is the name given to activity whereby credit unions purchase single family residential mortgages originated by mortgage companies, while the loans are awaiting resale to investors in the secondary market. An essential element of the program is that the credit union actually takes an ownership position in the loan, thus avoiding aggregation of the individual loans under an extension of credit to the originator. While temporary purchase programs may be employed in a variety of circumstances, they are most frequently associated with smaller originators who do not qualify for warehouse lines of sufficient size to handle the volume of their activity. In most temporary purchase programs, the credit union's purchase occurs simultaneous with the loan's funding and loan documents are closed in the mortgage company's name. Ownership is assigned to the credit union at closing, as is the purchase commitment from the secondary market investor which has been arranged by the originator.

A loan is normally owned less than 60 days pending the investor's final review. During this period, loan documents may be held by a variety of parties depending on the specific agreement between the credit union and the originating mortgage company. However, a true purchase cannot legally occur unless documents evidencing ownership are within the credit union's possession or control, either directly or through some type of custodial agreement with an independent third party. During the time a loan is owned by the credit union, any payments on the note are likely to be collected by a third party and remitted to the credit union, or held by an agent on the credit union's behalf. The credit union normally receives interest at the face rate on the mortgage loan purchased as well as a flat fee, which varies widely.

When the investor purchases a loan, the credit union recovers the principal, plus interest and fees. Any excess over the purchase price is forwarded to the originator as compensation for their services. If an investor rejects a loan or fails to honor its purchase commitment, the credit union owning the mortgage is responsible for regaining the original loan documents, carrying the loan, correcting any deficiencies, and potentially reselling the asset.

Field of Membership

As prescribed in 7 TAC Section 91.711, credit unions may only purchase a full ownership interest in loans to its members, and, as such, borrowers in a temporary purchase program must meet the field of membership requirements included in the credit union's bylaws and must become members of the credit union before or simultaneous with the actual purchase of the loan. Evidence of the prospective borrower opening a credit union membership account must be retained, along with all other pertinent documentation. As a reminder, credit unions must obtain all necessary information and follow all procedures for opening accounts as required under applicable law, including the Bank Secrecy Act, as amended by the USA PATRIOT Act, its implementing regulations, and any directives that may be issued.

Potential Risks

Due to the success reported by other institutions engaged in temporary mortgage purchase programs, credit unions and their boards may incorrectly believe that there is little risk in the activity. In fact, however, there are numerous incidents of financial institutions sustaining high losses when temporary mortgage purchasing programs are not prudently controlled. Due to the fact that much of the profit is derived from volume, even minor deficiencies may represent a significant threat to credit union capital if left undetected and allowed to compound. Credit unions that attempt to operate temporary purchase programs without sufficient expertise and controls may be cited for unsafe and unsound activity by the Department.

Risk of Fraud

Fraud in a temporary mortgage purchase program presents the largest risk to capital. This is particularly true to the extent that concentrations exist with any one mortgage originator. While the vast majority of mortgage companies perform their business legitimately, the ease of entry into the mortgage business and the emphasis on volume and quick inventory turnover make the industry susceptible to unscrupulous individuals. The weaker the financial condition of the mortgage company and the less effective a credit union's controls, the greater the likelihood of fraud occurring through: (1) multiple sales of the same loan to several parties; (2) alteration or misrepresentation of the credit quality of a borrower; (3) use of fictitious borrowers; or (4) misapplication of funds from the sale or amortization of the loan. Permanent investors do not have to honor commitments on fraudulent credits, and VA and FHA guarantees would not be enforceable. Therefore, any fraud is usually a total loss to the credit union.

Credit Risk

The nature of the temporary purchase program is such that a credit union will have exposure to credit risk in a number of forms. In the ordinary course of the transaction, credit exposure to the mortgage borrower is limited due to the fact that the credit union's period of ownership is confined. However, this exposure increases dramatically when a credit union is forced to repurchase or retain a loan due to early payment default or documentation deficiencies, since the credit union has acquired a longer term exposure in the face of mounting credit and market risk.

A credit union also must evaluate the credit and reputation of the originating mortgage company due to its reliance on that entity to underwrite and document the purchased loans. If a mortgage company is experiencing financial difficulties, cutbacks in personnel and controls may materially affect the quality of the loans being originated, as well as contribute to a failure to meet prescribed due dates. Also, the possibility of fraud increases in desperate financial situations

Finally, another source of credit risk is that resulting from reliance on the secondary market investor to buy out the credit union's position. Investors under financial stress or experiencing liquidity problems may default on their purchase commitments, particularly if they have failed to hedge their purchase commitments.

Concentrations

The high volume nature of temporary purchase programs often creates asset concentrations many times the level of capital, which amplifies all other risk aspects discussed in this section. Concentrations in loans from one originator, sold to any one investor, or from any geographic region should be closely monitored and controlled. Credit unions also should control the volume of mortgages and outstanding funding commitments from a liquidity and balance sheet management perspective.

Funding

Ideally, credit unions should fund assets with member deposits. However, some credit unions engaged in temporary purchase programs approach a volume and cyclical demand for funding which exceeds their capacity to generate from these deposits. Such credit unions may be tempted to reach out to higher cost and more volatile funding sources, which may adversely impact earnings and liquidity. Also, credit unions which rely on more expensive funds are more likely to compromise prudent standards of underwriting or controls in an effort to compensate for the higher priced funding. To the extent that maturities or repricing intervals are not aligned between the assets and underlying funding, the credit union also may be susceptible to interest rate risk.

Interest Rate Risk

Direct interest rate risk is minimal in a well-run temporary purchase program under which loans are pre-sold to a strong investor, who in turn has hedged their position. Any credit union, however, which purchases loans that have not been pre-sold, is effectively speculating on interest rate movements. This could have a dramatic impact on capital through required mark to market accounting in an adverse environment. Indirect interest rate risk is also evident to the extent that investors are more likely to renege on a commitment in a rising rate environment. Finally, because fee income and the value of servicing rights swing widely based on interest rates, the effect of a changing rate environment on the financial condition of mortgage companies should not be ignored.

Documentation/Market Risk

The structure of most temporary purchase programs is such that the credit union will not have direct control of the loan documents for much of the ownership period. This leaves the credit union highly reliant upon third parties to recognize and protect its ownership rights. Failure to adequately control this aspect of the transaction can subject the credit union to either a complete loss of a negotiable asset through misappropriation, or partial loss of value if only a portion of the original documents can be assembled in the case where the asset must be re-sold.

Documentation risk also arises through poor underwriting, or lost or defective supporting documents. These loans are likely to be rejected by the secondary market investor. In that case, the credit union must either hold the defective loan, or attempt to correct deficiencies and resale it. Generally, a credit union is likely to realize less than the full market price of the loan if forced to sell. In other instances, a credit union may not be in a position to permanently own any volume of mortgage loans due to the potential strain on its balance sheet and personnel.

Funds Transmittal Risk

Funds are transmitted twice during the typical life cycle of a temporarily purchased loan: from the credit union to the closing agent at the time the loan is originated; and from the investor to the credit union when the loan is purchased. If a credit union does not sufficiently control these transmittals, it runs the risk of the funds being misappropriated by either the originator or the closing agent. There have been instances when closing agents have colluded with mortgage originators and used loan proceeds in a manner other than represented to the financial institution, or allowed a loan to be sold to multiple purchasers. Also, mortgage originators may have the ability to override a credit union's wiring instructions to an investor, especially if the investor is a government-sponsored agency which provides the originator access to a portion of their data base. Therefore, unless precautions are exercised, the originator could directly receive purchase proceeds from the investor and not notify the credit union of loan sales.

Minimum Standards

The following criteria are outlined to provide a set of standards which should be employed by a credit union in establishing and/or reviewing a temporary purchase program. Due to the nature of risk, strong oversight should be evident for any credit union engaging in a temporary purchase program. Above all, it is essential that the credit union board ensure that adequate and competent staffing has been employed to oversee mortgage purchasing operations. Policies, comprehensive management information systems, quality control programs, and strategic and contingency planning are also essential to adequately protect capital.

Written Policy

A formal policy with specific limitations and control procedures is important to a well-run program. Components which should be included in such a policy include investment limitations, authorized loan products, maintenance of a list of approved mortgage companies and investors, limits on the purchase of loans which have not been pre-sold, and requirements for periodic reports to the board. Minimum requirements for participating originators, underwriting standards for loans purchased, and controls over the loan funding and sale transactions should also be addressed in a comprehensive policy.

Credit Approval Standards

A credit union should review and approve each loan prior to its purchase. The review should be sufficient to document the credit union's determination that the prospective borrower is eligible for membership, qualifies for the requested mortgage, and that debt service and collateral coverage are sufficient for credit union and investor requirements. Beyond a credit analysis of the borrower and a check of the accuracy of calculations, the documents should be subjected to some limited verification to determine their accuracy and authenticity. This could include a call to the borrower's employer, and contact with the appraiser to verify the estimated value of the property. The extent and scope of verification will depend on the strength of, and the credit union's experience with, a particular originator.

A credit review should be performed at least annually on each mortgage company selling to the credit union, along with periodic monitoring through interim reports. In reviewing and approving mortgage companies, consideration should be given to: site visits by credit union officers; analysis of both audited and interim financial statements; review of credit reports on the company and its owners; verification of fidelity bond and errors and omissions insurance coverage; verification of any necessary state license; review of the "master sales commitment" agreements between the mortgage company and secondary market investors; verification of HUD/FNMA/FHLMC investor status; and review of HUD/FNMA/FHLMC quality control audits if applicable. To the extent that historic performance and rejection information may be available, this would also provide an important insight into a company's capacity to perform.

An analysis of the permanent investors to whom loans are sold is also prudent. Considerations appropriate to this review could include a review of a company's ratings under third party rating services; an analysis of audited annual financial statements; and/or the company's performance under past purchase commitments. The investor's willingness or ability to honor the credit union's bailee letters and comply with prudent sale closing standards (such as responding to verification requests and direct wiring of remittance funds), also should be strongly weighed.

Written Agreements with the Mortgage Company

In order to specifically define the rights and responsibilities between the credit union and selling mortgage companies, a board approved written agreement should be in place for each company selling loans to the credit union. The agreement should address items such as: minimum standards for participating in the program (licensing, bonding, etc.); procedures for handling mortgage loan deficiencies; provisions for acquiring copies of important agreements between the mortgage company and other third parties; procedures for timing and submission of documents to the credit union to facilitate pre-purchase review; and the responsibilities of each party in regard to mortgage loan defaults.

Mortgage Closing Standards

Most closings under a temporary purchase program are "table funded" by the credit union at an independent title company or title attorney's office. Internal control over the closing process is very important to safeguard the credit union's interests. Steps which should be taken include: direct (telephonic) confirmation with the investor of the purchase commitment; direct or indirect receipt of the original endorsed note and assignment, and certified copies of other documents prior to funding; receipt of an insured closing protection letter verifying fidelity and errors and omissions coverage on the closing agent; acknowledged wiring instructions to the closing agent; and limitation of disbursement at closing to less than the full secondary market price (to avoid pre-paying the originator's and closing agent's fees).

Sale Closing Standards

Credit unions should insist that they receive direct payment of sale proceeds by the investor. To ensure against stale inventory or potential misappropriation of sales proceeds, credit unions also should carefully monitor any loan on the books for over sixty days, and follow up on any sales which do not occur on or before the target purchase date.

Quality Control Program

Credit unions engaging in a temporary purchase program should have a system of quality control which provides a means to identify potential weaknesses and risks in the program. Included in the system would be an independent audit of a portion of loans purchased, the scope and extent of which would vary depending on: the types of loans being purchased; the credit union's knowledge of the loan originator; and the financial condition and historical performance of the originator. An audit of up to 10-15% of the loans purchased is an industry best practice, with a larger sample employed for a new originator, or one experiencing financial difficulties. The audit should verify that all elements of the transaction complied with the credit union's policies and procedures, as well as re-verify elements of the purchased loan.

Management Information Systems

Comprehensive management information systems are essential to the smooth operation of a temporary purchase program. Credit union management should have detailed and timely reports for supervising daily activity, while the board of directors should receive periodic summary reports on the volume of activity, exceptions, and profitability. It is also important to track: historic data on failed sales; the number and dollar volume of loans rejected by investors; and, documentation/underwriting exceptions by loan production source.

Contingency Planning

Board-approved contingency plans are strongly recommended for programs of any material size to provide a basis for responding to potential interruptions in the program. The "temporary" ownership may become long-term should loans be rejected by investors. Any legal or implied recourse from the investor to the credit union should be considered as well. The credit union's ability to retain some portion of the loans awaiting resale should be evaluated based on a reasonable "worst case" scenario (such as maximum exposure to any one investor). To the extent any actual recourse exists, the credit union should identify funding mechanisms and liquidity sources to buy ineligible loans back from the secondary market if necessary.

Reserve Standards

The Allowance for Loan and Lease Losses should provide coverage for any risk of credit loss from the mortgages owned by the credit union. In determining how much should be allocated, historic loss experience may be one consideration. Other items which may be assessed include: the risk of investor default; the impact of interest rates on borrowers' repayment capacity on adjustable rate mortgages; and the level of government-sponsored loans. If any loans are sold with recourse to the credit union, separate recourse reserves should be established.

Accounting Standards

The credit union should ensure that accounting techniques comply with generally accepted accounting principles and that activity is correctly reported in regulatory reports. Formal systems should be in place to: document the proposed disposition of each loan at the time of purchase; ensure that loans are recorded as "held for sale" and reported at the lower of cost or market in accordance with Financial Accounting Statement (FAS) 65 (Accounting for Certain Mortgage Banking Activities); and, defer loan fees in excess of cost in accordance with FAS 91 (Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases).

Conclusion

The Department supports credit union involvement in the mortgage lending process. Not only do members benefit from increased credit availability, but credit unions operating with sufficient controls are able to acquire relatively low-risk assets at favorable yields. Temporary mortgage purchase programs allow credit unions to participate in the mortgage market without having to develop and staff internal origination operations. However, because of the volume of most programs and a substantial element of risk involved, strong board and management oversight is essential.

Credit Union Department

REGULATORY BULLETIN

December 3, 2014 RB 2014-03

Guidance on Indirect Automobile Lending

Introduction

Many traditional aspects of indirect automobile lending have changed in recent years. The captive finance companies of automobile manufacturers have made the auto lending business more difficult for credit unions. In an effort to compete for automobile loans, many credit unions have tried to match the financial concessions of competitors by relaxing underwriting standards and cutting corners on processes and procedures. As a result some credit unions are operating in the highly competitive market with weak controls and lax loan underwriting programs, with predictable consequences. Further, it should also be noted that even credit unions with stronger programs are susceptible to diminishing collateral values and increased risk as loan terms are extended over longer periods.

Traditionally, the Department and credit unions have relied on a delinquency-based approach to evaluate automobile loan portfolios. This approach has served regulators and credit unions well in the past, but recent automobile financing trends require a more in-depth analysis when loan and collateral values are not correlated, vehicles are financed multiple times, or losses are deferred and embedded in loan balances.

This guidance reminds credit unions of certain aspects in the process that should be followed to prudently manage the risks associated with indirect loans. While there are benefits to a well-run indirect lending program, an improperly managed or loosely controlled program can quickly lead to unintended risk exposure. It takes proper planning and adequate controls and monitoring to make this type of program profitable and a productive activity for serving credit union members.

Background

Credit unions develop indirect automobile lending programs by establishing relationships with automobile dealers. Credit unions define the type of borrower and loan they will accept by providing dealers with underwriting and interest rate guidelines. In many cases, a dealership gathers credit information from prospective buyers, completes loan applications, and forwards the documents to the credit union for approval. Historically, automobile financing has been perceived as a lower-risk form of lending, with risk spread among a large volume of smaller-balance, collateralized loans. Recent instances of weak indirect automobile lending programs, however, have indicated insufficient collateral values and marginal or deficient borrower repayment capacity, resulting in substantial financial consequences for the credit union.

Some evidence suggests that increased competition is negatively influencing indirect automobile lending programs. Heightened competition has prompted credit unions to offer lower interest rates, lengthen amortization periods, and scale down payment requirements. In some cases, competition has prompted credit unions to grant lending authority to the dealer in order to expedite the approval process for loans that fall within credit union-approved guidelines. Credit unions sometimes have extended their risk selection standards to enable them to finance lower credit quality accounts, often referred to as subprime loans. Today's indirect automobile lending practices represent unique challenges to credit unions and the Department.

Types of Programs

In today's marketplace, there are generally two types of automobile programs which are being utilized by credit unions. The first and most prevalent is a point of sale (indirect) relationship where the dealership provides loan application documentation, allowing the credit union to underwrite and decision the credit worthiness of the prospective borrower. If the prospective borrower qualifies for membership and an extension of credit, the borrower contracts directly with the dealership for the purchase of the automobile and subsequently the dealer assigns the resulting retail installment contract (indirect loan) to the credit union. Normally an indirect program is evidenced by a contractual relationship between the credit union and the participating dealership. The second program is less formal and is typically referred to as a “dealer referral program”. As part of a referral program, the dealer may send the prospective borrowers directly to the credit union. The credit union may then qualify the borrowers for membership, and underwrite and decision the extension of credit utilizing the credit union's internal loan standards. Regardless of the type of program, a credit union must be careful not to get lulled into a false sense of responsibility to approve loans. Ineffective underwriting and weak decision-making may result in high delinquencies and potentially larger charge-offs for the credit union. Under either program, if the loan losses become excessive, it can place the safety and soundness of the credit union and its future viability at risk.

Additional Scrutiny

Credit unions must recognize the additional risk inherent in today's indirect lending and determine if these risks are acceptable and controllable given the credit union's staff, financial condition, size, and level of net worth. Credit unions that engage in indirect lending in any significant way should have board-approved policies and procedures, as well as internal controls that identify, measure, monitor, and control these additional risks. The initial development of a sound indirect program includes a documented analysis of existing programs within the local marketplace. The analysis should include dealer reserve structures (i.e. flat fees, rate mark-up limitations, etc.); maximum loan maturities based on amounts financed; minimum credit scores allowed; maximum limits for "add-on" products; loan to value limits; and the basis for collateral valuation (NADA trade, retail, etc.). This analysis should provide the credit union with the basic framework to develop its indirect program limits. As part of the ongoing due diligence process for any indirect program, this type of analysis should continue on a regular basis throughout the life of the program. Another pertinent consideration during the implementation phase of the program is whether the credit union's program will be geared toward franchise or non-franchise dealers, or a mixture of both. Generally speaking, non-franchise dealers may not possess the same level of financial stability as franchise dealers, and may not have the same quality of internal control processes in place. In some instances, this could elevate the potential for fraudulent transactions. Credit unions that engage in a small volume of indirect lending should have systems in place commensurate with their level of risk. Credit unions with existing indirect lending programs should carefully consider whether their program meets the following guidelines and should implement corrective measures for any area that falls short of these minimum standards.

The Department recognizes each credit union has its own individual risk profile and tolerance levels. However, as part of its ongoing supervisory monitoring processes, the Department will use certain criteria to identify credit unions that are potentially exposed to significant indirect lending risk. A credit union that has experienced rapid growth in indirect lending, has notable exposure to a particular credit risk category, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis to assess the nature and risk posed by the indirect lending program:

- Total reported indirect loans represent 250 percent or more of the credit union's net worth; or
- Total reported indirect loans represent 25 percent or more of the credit union's aggregate loan portfolio.

Field of Membership

As indicated by Section 122.253 of the Finance Code, credit unions may only make loans to its members, and, as such, borrowers in an indirect loan program must meet the field of membership requirements included in the credit union's bylaws and must become members of the credit union. Before underwriting and making a decision on a potential extension of credit, a credit union should ensure the dealership provides adequate documentation to confirm whether the prospective borrower qualifies for membership. Evidence of the prospective borrower opening a credit union membership account must be retained, along with all other pertinent documentation. Further, a credit union must obtain all necessary information and follow all procedures for opening accounts as required under applicable law, including the Bank Secrecy Act, as amended by the USA PATRIOT Act, its implementing regulations, and any directives that may be issued. These requirements are in addition to the documents and disclosures required to be given or completed in conjunction with the extension of credit.

Risk Management

Prior to engaging in an indirect automobile lending program, the board and senior management of the credit union should ensure that proposed activities are consistent with the credit union's overall business strategy and risk tolerances, and that the credit union has properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target borrowers, and performance expectations and benchmarks for each segment and the portfolio as a whole. Credit unions establishing an indirect lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if initial profitability estimates are realistic and sustainable.

Staff Expertise

Indirect lending programs require specialized knowledge and skills that some credit unions may not possess. Account originations and collection strategies and techniques often differ from those employed for existing members; thus it may not be sufficient to have the same lending staff responsible for both indirect loans and other loans. Additionally, servicing and collecting indirect loans can be more labor intensive. If necessary, the credit union should implement programs to train staff. The board should ensure that staff possesses sufficient expertise to appropriately manage the risk in indirect lending and that staffing levels are adequate for the planned volume of indirect activity. Seasoning of staff and loans should be taken into account as performance is assessed over time.

Dealer Due Diligence Review Process

Credit unions should perform a thorough due diligence review of any participating dealer prior to purchasing an indirect loan. Credit unions should not accept indirect loans from dealers that do not meet their underwriting criteria, and should regularly review whether the prospective borrowers being offered by a dealership meet the established criteria. Deterioration in the quality of indirect loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the dealers who originated the loans, as well as reevaluation and adjustments of the credit union's criteria for underwriting indirect loans and selecting dealers. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship.

Loan Underwriting and Administration Procedures

After the indirect loan is purchased, loan administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful indirect lenders have historically employed stronger collection efforts such as calling delinquent borrowers frequently, assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to repossess collateral, and allowing few loan extensions. This aspect of indirect lending is labor intensive but critical to the program's success. To a large extent, the cost of such efforts can represent a tradeoff relative to future loss expectations when a credit union analyzes the profitability of indirect lending and assesses its appetite to expand or continue this line of business.

Credit unions should keep in mind that a large percentage of the borrowers in an indirect lending program may be new members to the credit union. These new members may not possess the same level of loyalty to the credit union as other segments of the existing membership. As a result, the collection efforts may need to be modified to begin contact earlier with the indirect loans than with other segments of the loan portfolio.

The credit union should be cautious about using different types of credit scores to qualify indirect borrowers than is used for existing borrowing members. The use of alternative credit scores, such as “auto enhanced,” can place more emphasis on the repayment of certain loans in comparison to other outstanding debt obligations and the scoring model may provide a higher credit score than a standard credit bureau score. In addition to potentially increasing credit risk, the lack of consistency between the use of different types of credit scores can create discrepancies in the analysis of the credit quality of the entire loan portfolio.

Loan Review and Monitoring

Once indirect loans are booked, credit unions must perform an ongoing analysis of these loans, not only on an aggregate basis but also for sub-categories. Monitoring performance for the entire indirect loan portfolio as well as by dealer is a critical factor to ensure the success of an indirect program. This monitoring may include the tracking of both early stage (i.e. 15 to 29 days; 30 to 59 days) and reportable delinquencies (60+ days), by dealer and credit score categories for each dealer. Additionally, the tracking of loan losses by dealer (broken down by credit risk categories) is a strong monitoring process. Credit unions should have information systems in place to segment and stratify their indirect portfolio (e.g., by dealer, loan-to-value, credit scores) and produce reports for the credit union to evaluate the performance of the indirect loan portfolio. In addition, comparison of the indirect segment relative to the credit union's total loan portfolio and other loan segments (i.e. direct auto loans) can provide the credit union valuable insight as to the performance trends of the indirect program. The review process should focus on whether performance meets expectations. Credit unions then need to consider the source and characteristics of indirect loans that do not meet expectations and make changes in their underwriting policies and loan administration procedures to restore performance to acceptable levels.

When evaluating actual performance against expectations, it is particularly important that the credit union review credit scoring, pricing and the adequacy of the Allowance for Loan and Lease Losses (ALLL). ALLL adequacy driven by the volume and severity of historical losses experienced during good economic times may have little relevance in an economic slowdown.

Reevaluation

Credit unions should periodically evaluate whether the indirect lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause and the program should be modified appropriately. If the program falls short of the credit union's expectations, the board and senior management should consider terminating it. Questions that the board and senior management need to ask may include:

- Have cost and revenue projections been met?
- Have projected loss estimates been accurate?
- Were the risks inherent to indirect lending properly identified, measured, monitored, and controlled?
- Has the program met the credit needs of the members that it was designed to address?

Compliance Considerations

Indirect automobile lending can also expose credit unions to compliance risk, particularly related to fair lending and unfair and deceptive practices. It is important to determine whether a credit union is considered a creditor and whether an agency relationship exists with the dealer. A creditor is defined by Regulation B. There can be multiple creditors in a single credit transaction. In indirect automobile lending there are usually at least two: the credit union and the dealer.

A credit union buying dealer paper (i.e., loans that have already been made) that did not influence and was not involved in the credit decision in any manner is not considered a creditor under Regulation B. However, a credit union that either influenced or was involved in the credit decision is considered a creditor and is subject to all fair lending regulations. It is also essential to determine the nature of the relationship between a credit union and an automobile dealer. Credit unions are directly responsible for any discriminatory pricing or other discriminatory decisions made by a dealer acting as an agent of the credit union.

Credit unions should also monitor automobile lending programs for any evidence of unfair or deceptive conduct. Such conduct may arise through sales practices as well as through the financing and repossession process. Credit unions should consider incorporating a post audit process where the credit union contacts new borrowers (randomly, by dealership) to confirm a few key elements (i.e. term, rate, collateral including make and model, etc.) of the indirect loan to ensure there is no evidence of unfair or deceptive conduct.

Summary

Competition in the automobile lending market has increased significantly in recent years and is not expected to diminish in the near future. The results are thinning collateral and smaller net interest margins. The potential for heightened risk to credit unions in the areas of compliance, and safety and soundness, can be mitigated only through prudent lending policies and procedures, adequate internal controls, and strong oversight.

Texas Credit Union Department

REGULATORY BULLETIN

December 27, 2016 RB 2017-01

Guidance on Member Business & Commercial Loans

INTRODUCTION

On November 4, 2016, the Credit Union Commission approved certain changes to 7 TAC Section 91.709 concerning the ability of a credit union to make member business loans (MBLs). These amendments to the rule are effective January 1, 2017.

The newly amended rule eliminates the prescriptive underwriting criteria of the existing rule, thereby eliminating the current waiver process. Instead the new rule allows credit unions to implement a principle-based risk management policy related to its commercial and business lending activities. More specifically, the new rule:

- Gives credit unions the ability, under certain circumstances, to not require a personal guarantee;
- Replaces explicit loan-to-value limits with the principle of appropriate collateral and eliminating the need for a waiver;
- Abolishes the 15 percent net worth aggregate limit on construction and development loans; and
- Exempts credit unions with assets under $250 million and small commercial loan portfolios from certain requirements.

The new rule revamps the way that the Department approaches commercial lending, from both a regulatory and supervisory perspective. Currently, Rule 91.709 considers commercial lending as synonymous with the member business lending definition. The new rule distinguishes between the specific category of statutorily defined MBLs and the universe of commercial loans that a credit union may extend to a borrower for commercial, industrial, agricultural, and professional purposes. As a result, member business loans that are also commercial loans will follow the newly prescribed commercial loan policies. Member business loans that are not commercial loans will follow the credit union's general loan policies. In addition, the new rule delineates which loans are subject to the statutory MBL cap and those which are subject to certain safety and soundness policy and infrastructure requirements.

Although the new rule will give credit unions greater latitude in making commercial loans, it also imposes greater responsibilities. Credit unions will be required to demonstrate sound judgement in originating commercial loans, and control systems will need to be appropriate for the risk inherent in the business loan portfolio.

Commercial Loans versus MBLs

Under the new rule, there are several distinctions between a commercial loan and a member business loan. These apply whether a credit union directly offers a loan or purchases a loan or participation. It is important to understand the differences, as loans recognized as commercial loans must be evaluated based on the risk management principles outlined in Rule 91.709. Loans recognized as member business loans must be reported as such for quarterly call reporting and kept within the statutory MBL limit. In all cases, a credit union should perform appropriate risk assessment to ensure a loan is supported by a reliable and adequate repayment source.

A business loan is any loan, line of credit, or letter of credit (including any unfunded commitments) made to a person for commercial, industrial, agricultural, or professional purposes (but not for personal expenditure purposes). The following table illustrates types of loans which must be recognized as either a MBL or a Commercial Loan, or as neither.

Type of Loan	MBL	Commercial Loan	Subject to Aggregate MBL Cap
Loan fully secured by a 1 to 4 family residential property (member's primary residence)	No	No	No
Business loan fully secured by a 1- to 4-unit family residential property (not a member's primary residence)	Yes, if the aggregate net business loan balance is equal to or greater than $50,000	No	Yes, if the aggregate net business loan balance is equal to or greater than $50,000
Business loan secured by a vehicle manufactured for household use	Yes, if the aggregate net member business loan balance is equal to or greater than $50,000	No	Yes, if the aggregate net business loan balance is equal to or greater than $50,000
Business loan secured by a vehicle used in a fleet or to carry fare-paying passengers	Yes, if the aggregate net member business loan balance is equal to or greater than $50,000	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000

Type of Loan	MBL	Commercial Loan	Subject to Aggregate MBL Cap
Business loan with aggregate new member business loan balance less than $50,000	No	No	No
Business loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions	No	No	No
Business loan in which a federal or state agency (or its political subdivision) fully insures repayment, fully guarantees repayment, or provides an advance commitment to purchase the loan in full	No	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000
Non-member business loan or non-member participation interest in a commercial loan made by another lender	No	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000

Exemption for Smaller Credit Unions with Limited Commercial Lending Activities

Rule 91.709 applies to all credit unions; however, smaller credit unions that hold a relatively small amount of commercial loans compared to its net worth and infrequently originates and sells commercial loans is exempt from Sections 91.709(c)(1) [commercial loan policies] and 91.709(c)(2) [qualified staff] of the rule. In order to qualify for the exemption, a credit union must satisfy all of the following conditions:

- Less than $250 million in total assets

- Aggregate amount of outstanding commercial loan balances and unfunded commitments, plus any outstanding commercial loan balances and unfunded commitments of participations sold, plus any outstanding commercial loan balances and unfunded commitments sold and serviced by the credit union total less than 15 percent of the credit union's net worth[i].

- Amount of commercial loans originated and sold (which the credit union does not continue to service) total less than 15 percent of the credit union's net worth in a given calendar year.

All credit unions must have a board-approved loan policy covering their lending activity in general, including those credit unions that qualify for the exemption. A credit union that meets the criteria outlined above is only exempt from the specific policy and infrastructure requirements of Sections 91.709(c) (1) and (2). Exempt credit unions must ensure their general loan policy (required by Rule 91.701) covers the types of commercial loans the credit union makes, including satisfying all other applicable commercial lending requirements in Rule 91.709.

Underwriting Standards

Underwriting standards for commercial loans should be clear, measurable, and reflect the level of risk acceptable to the board of directors. A credit union must establish and maintain prudent credit underwriting practices that provide for consideration, before credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed.

The new rule provides that a credit union's commercial loan policies must address the required analysis and depth of the financial review performed to support a credit decision. The credit union should obtain appropriate financial information on the borrower(s) and guarantor(s), if applicable, including income, liquidity, cash flow, contingent liabilities, and other relevant factors. A borrower should demonstrate the capacity to meet a realistic repayment plan from available liquidity and cash flow. Cash flow from the underlying property or other indicators of borrower capacity should be evaluated to determine whether, and to what extent, the borrower can adequately service interest and principal on a prospective loan.

A credit union's underwriting standards must also address the quality of the financial information used to make a credit decision and ensure that the degree of verification reflected in the financial information is sufficient to support the financial analysis and the risk assessment of a credit decision. A credit union can determine the quality of a financial statement using the level of assurance provided by a preparer and the required professional standards supporting the preparer's opinion.

Construction and Development Loans

Construction and development lending is a highly specialized field with inherent risk that must be managed and controlled to ensure that this activity remains cost-effective. A credit union's ability to identify, measure, monitor, and control portfolio risk through effective underwriting policies, systems, and internal controls is crucial to a sound construction and development program.

While many of the risks associated with a construction and development lending are beyond the control of the credit union, some can be mitigated by (1) careful scrutiny of the plans and budget; (2) frequent and routine inspections; (3) thoroughly investigating the financial condition and reputation of the borrower; and (4) utilizing effective loan administration procedures. In particular, credit unions are expected to maintain effective policies and procedures governing the loan disbursement process. It is important that any advancement of funds is commensurate with improvements made. Controls should include inspection processes, documentation of construction progress, and exception monitoring and reporting. The credit union should not disburse funds unless the funds are to be used solely for the project being financed and as stipulated in the draw request and governed by the loan agreement.

Risk Rating Commercial Loans

Credit unions are expected to maintain credit risk-management systems that produce accurate and timely risk ratings. Early and accurate risk identification is critical to ensuring problem loans are identified in a timely manner. This enhances flexibility in troubled loan resolution, contributes to the timely recognition of losses, and enables the maintenance of an appropriate ALLL balance. Credit risk rating should be reviewed and updated whenever relevant new information is received.

Periodic independent reviews should be conducted to verify the accuracy of ratings and the operational effectiveness of the credit union's risk-rating processes. Objective reviews of credit risk levels and risk-management processes are critical to effective portfolio management.

Commercial Lending Examination

In addition to the Department's standard loan quality review, a key focus of future commercial lending examinations will be on the effectiveness of a credit union's risk management process and the aggregate risk profile of a credit union's loan portfolio. The Department will be assessing whether a credit union's:

- Board of directors understands the risks and provides sufficient oversight;
- Management and staff have appropriate experience, expertise, and resources;
- Commercial loan policy is adequate and complies with Rule 91.709;
- Credit risk ratings are consistent and reliable; and
- Commercial loan risk management is comprehensive and ongoing.

Conclusion

Commercial lending can be an important line of business for a credit union and the new rule provides credit unions with greater flexibility and individual autonomy in safely and soundly making commercial loans to meet the needs of their membership. History has shown that imprudent risk taking and inadequate risk management can lead to significant losses and be a major cause of credit union troubles. This is particularly true during periods of rapid economic growth.

One of the key elements of risk in this type of lending is the cyclical nature of the markets where, as markets peak and decline, credit unions with larger concentrations of commercial loans may suffer considerable distress. While credit unions cannot accurately predict or control the timing of the business cycle, credit unions that demonstrate faithful adherence to prudent lending practices and controls can keep losses from commercial lending to a manageable level, even when markets experience significant stress.

[i] This threshold is measured against all commercial loans in a credit union's portfolio, as well as whole commercial loans or commercial loan participations a credit union has sold but continues to service. For example, a credit union has $20 million in commercial loans including unfunded commitments. In addition, the credit union has sold $10 million in commercial loan participations, including unfunded commitments, and $5 million whole commercial loans, including unfunded commitments with servicing retained. In this example, the aggregate amount of commercial loans that need to be measured against the 15 percent of net worth threshold would be $35 million.